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Report No. 1519
January 9, 2026

The Honorable Scott Bessent
Secretary
Department of the Treasury
and
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Kenneth Kies
Assistant Secretary (Tax Policy)
Department of the Treasury
and
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

<u>Re: NYSBA Tax Section Report No. 1519 - Report on Various Issues Arising Under Section 704(c)(1)(A)</u>

Dear Secretary Bessent and Assistant Secretary Kies:

Please find attached Report No. 1519 of the Tax Section of the New York State Bar Association. The Report provides comments and certain recommendations of the Tax Section regarding section 704(c)(1)(A) of the Internal Revenue Code, which governs the allocation of partnership items with respect to partnership property with a tax basis that differs from its fair market value. The rules under section 704(c)(1)(A) are generally intended to prevent inappropriate shifting of tax consequences among partners with respect to pre-contribution gain or loss.

The Report identifies the need for additional guidance under section 704(c)(1)(A) with respect to a number of important topics and provides our recommendations on specific issues that we consider most critically in need of additional guidance.

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We appreciate your consideration of this Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Andrew Walker
Chair

Enclosure

Cc (by email):

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Report No. 1519

New York State Bar Association

Tax Section

Report on Various Issues Arising Under Section 704(c)(1)(A) of the Internal Revenue Code

January 9, 2026

Opinions expressed are those of the Tax Section and do not represent those of the New York State Bar Association unless and until they have been adopted by its House of Delegates or Executive Committee.

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Report No. 1519

I. Introduction

This Report of the Tax Section of the New York State Bar Association[1] analyzes various issues arising under section 704(c)(1)(A) of the Internal Revenue Code of 1986, as amended (the "**Code**").[2]

Part II summarizes our principal recommendations for guidance from the Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") with respect to certain rules under section 704(c)(1)(A). Part III provides general background on section 704(c)(1)(A). Part IV then analyzes a number of issues under section 704(c) and discusses our recommendations for guidance.

II. Summary of Principal Recommendations

The Code includes many provisions that limit the shifting of gain and loss between partners that can result from the contribution of appreciated and depreciated property to a partnership, including section 704(c)(1)(A). Although there are Treasury regulations implementing these provisions, substantial guidance is needed in several areas. We identify and provide detailed recommendations for guidance on certain of these areas in Part IV below.

Our principal recommendations include the following:[3]

1. Treas. Reg. § 1.704-3(a)(8)(i) should be amended to provide a clear rule on the approach taxpayers may (or must) use to allocate basis to the share(s) of stock received in section 351(a) exchanges, subject to the application of the reasonableness requirement of Treas. Reg. § 1.704-3(a)(1). If the "specific identification" approach is required, Treasury and the IRS should provide additional guidance on how the specific identification approach applies to particular situations, including those involving a partial disposition.

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[1] The principal authors of this Report are Aliza Slansky and Eric Sloan, with substantial assistance from Eytan de Gunzburg, Dov Sussman, and Constance Zhang. Helpful comments were received from Sarah Brodie, Robert Cassanos, Tim Devetski, Matthew Donnelly, Meyer Fedida, Phillip Gall, Larry Garrett, Craig Gerson, Edward Gonzalez, James Jennings, Stephen Land, James Manzione, Elliot Pisem, Arvind Ravichandran, Jennifer Ray, Stuart Rosow, Michael Schler, Kendra Simpson, Joseph Tootle, Shun Tosaka, Sara Zablotney, and Libin Zhang.

[2] Except as otherwise indicated, all references to "**section**" are to the Code, and all "**Treas. Reg. §**" and "**Prop. Treas. Reg. §**" are to the Treasury regulations promulgated under the Code.

[3] Capitalized terms not defined in this Part II have the meanings ascribed to them in Parts I, III and IV.

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2. Treas. Reg. § 1.704-3(a)(8)(i) should be amended to provide that partnerships should be permitted to use any reasonable method to apportion section 704(c) amounts among retained section 704(c) property and substitute section 704(c) property in connection with partial dispositions of section 704(c) property in nonrecognition transactions, subject to the application of the reasonableness requirement of Treas. Reg. § 1.704-3(a)(1).

3. Treas. Reg. § 1.704-3(a)(7) should be amended to provide that the transferee partner inherits a share of the transferor's built-in gain or loss that is "attributable," rather than "proportionate," to the interest that is transferred.

4. Treasury and the IRS should confirm that Treas. Reg. § 1.704-3(a)(9) is not by its terms exclusive and does not preclude the application of its principles to other tiered partnership scenarios. Moreover, Treasury and the IRS should make clear that the failure to apply the principles of Treas. Reg. § 1.704-3(a)(9) may be unreasonable and may lead to the application of Treas. Reg. § 1.704-3(a)(10). In particular, Treas. Reg. § 1.704-3(a)(9) should be amended to clarify that the use of a curative allocation method or remedial allocation method with respect to items allocated by a lower-tier partnership (an "**LTP**") to an upper-tier partnership (a "**UTP**") is permitted.

5. The regulations under section 704(c) and under section 755 should be amended to clarify that contingent income items, such as deferred revenue, are property for purposes of sections 704(c) and 755 and that a partnership should allocate basis adjustments to that section 704(c) property to ensure that only the partners who have received the economic benefit of that property include the tax items in income when recognized by the partnership for tax purposes.

6. Treas. Reg. § 1.704-3(c) should be revised to explicitly clarify that reasonable incomplete curative allocations are permissible, and an example should be added to Treas. Reg. § 1.704-3(c)(4) showing reasonable incomplete curative allocations. In addition, Treas. Reg. § 1.704-3(c)(3)(ii) should be amended to provide partnerships with the ability to make reasonable make-up curative allocations in accordance with the 1992 Proposed Regulations (as defined below).

7. The regulations under section 734(b) should be amended to provide that if a partnership uses the remedial allocation method with respect to an item of depreciable or amortizable property, the portion of any section 734(b) adjustment that is allocated to the section 704(c) property for which the remedial allocation method is used is recoverable over the remaining section 704(b) recovery period of such property. In addition, Treasury and the IRS should provide that in situations in which guidance with respect to

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the application of section 734(b) to section 704(c) is lacking, partnerships may make reasonable adjustments to section 704(b) book amortization and section 704(c) allocations to prevent (or minimize) the creation of book-tax disparities.

8. The regulations under section 755 should be revised to ensure that, to the maximum extent possible (taking into account section 751(b)), section 734(b) adjustments are allocated among partnership assets in a manner that avoids creating or increasing inside-outside basis disparities. Moreover, Treasury and the IRS should issue guidance confirming that the manner in which a section 734(b) adjustment reduces different partners' shares of section 704(c) amounts in a particular asset is a section 704(c) method.

9. Treas. Reg. § 1.704-3(a)(6) should be amended to provide that a distributee-partner's share of reverse section 704(c) gain resulting from a distribution of hot assets by a partnership should be increased to the full amount of the gain in the distributed hot assets and limited by the extent to which the distributee-partner's share of reverse section 704(c) gain in such partnership's retained hot assets can be decreased, provided that the distributed hot assets and the retained hot assets have the same type of built-in gain.

10. With respect to the contribution of appreciated or depreciated debt instruments (and other similar types of assets described further below), partnerships should be permitted to cure ceiling rule distortions with respect to that property with non-basis derivative income earned from the contributed property.

11. Treasury and the IRS should confirm that tax items could be allocated among multiple section 704(c) layers using any of the following reasonable methods: the "last in first out" method, the "first in first out" method, the pro rata method and the discretionary method, in each case subject to the general reasonableness requirement of the section 704(c) regulations.

12. The regulations under section 704(c) should be amended to confirm that (i) if costs with respect to section 704(c) property are properly capitalized into inventory or other property, the inventory or other property should be treated as section 704(c) property with the same amount of built-in gain or built-in loss as corresponds to the amount capitalized and (ii) the allocation method with respect to the inventory must be consistent with the method chosen for the original property.

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III. Background on Section 704(c)(1)(A)

Section 704(c) was first enacted in 1954. Prior to the 1954 code, little of partnership tax law was codified. In 1954, the American Law Institute (the "**ALI**") undertook a significant project to settle various aspects of partnership tax law. One of the important issues the ALI observed was "the proper treatment of depreciation and gains and losses in respect of contributed property."[4] The ALI considered three solutions to the problem. The first was the deferred sale method, which treats the contribution as producing a sale as of the date of the contribution, with the tax generally deferred until a later recognition event.[5] The second and the third solutions would have both provided that the partnership allocate tax items based on its carryover basis in the property it received without addressing any issues caused by the basis-value disparities. In the second solution, each partner's basis in its partnership interest would reflect the basis of the property contributed by that partner.[6] By contrast, the third solution considered by ALI was that each partner's basis in its partnership interest would reflect its share of the aggregate basis of all properties contributed to the partnership.[7] With respect to both the second and third solutions, the partnership has a carryover basis in the contributed property, and all allocations of tax items would be shared in the same manner as the relevant economic item was shared. The 1954 code effectively adopted the second solution,[8] while permitting the partnership to elect to specially allocate gain or loss to account for the variation between the tax basis and the fair market value of the contributed property.[9] Commentators pointed out that under this general rule, where partnerships were not required to allocate gain or loss to account for variation between basis and fair market value of contributed property, it was particularly compelling for high-income-bracket taxpayers who owned appreciated property to enter into partnerships with low-income-bracket taxpayers.[10]

Between 1955 and 1984, the statutory language remained the same. In 1984, Congress once again focused on section 704(c) and how gain or loss could be shifted within a partnership, and section 704(c) as it existed since 1954 was overhauled. What had once been elective under former section 704(c)(2) of the 1954 code became mandatory for all

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[4] American Law Institute, *Income Tax Project – Preliminary Draft No. 71*, at 195 (1951).

[5] *Id*. at 120-23. The later event that triggered recognition (of all, or a portion, of the gain) could include, among other things, a sale of the asset or cost-recovery deductions with respect to the asset.

[6] *Id*. at 124.

[7] *Id*. at 127.

[8] Section 704(c)(1) (as in effect before the Deficit Reduction Act of 1984, Pub. L. No 98-369, 98 Stat. 494).

[9] Section 704(c)(2) (as in effect before the Deficit Reduction Act of 1984, Pub. L. No 98-369, 98 Stat. 494).

[10] Charles W. Davis, *Partners and Partnerships: Determination of Tax Liability Under the 1954 Code*, 32 Taxes 964, 971-72 (Dec. 1954).

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partnerships when Congress enacted section 704(c)(1)(A).[11] The Treasury regulations under section 704(c)(1)(A), which have remained in substantially the same form since 1993, provide a set of rules that are intended to ensure that the partner that contributes property with a difference between FMV and tax basis retains the tax attributes associated with that difference. As explained by the Treasury regulations, "[t]he purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss."[12] The Treasury regulations focus particularly on shifts that have the effect of reducing "the present value of the partners' aggregate tax liability,"[13] while specifically acknowledging that partnerships are not required to allocate items so as to maximize the partners' tax liabilities.[14] In 1989 and 1992, Congress further restricted any potential for shifting by enacting sections 704(c)(1)(B) and 737, respectively.

Allocations with respect to section 704(c) property[15] must take into account the difference between the adjusted tax basis of the property and its fair market value at the time of the contribution using a reasonable method that is consistent with the purpose of section 704(c).[16] The section 704(c) regulations set forth three methods that generally are considered reasonable: (i) the traditional method, (ii) the traditional method with curative allocations, which comprises a number of allocation methods commonly referred to collectively as the "curative allocation method" and (iii) the remedial allocation method.[17] The general objective of each method is to put each partner that did not contribute a particular asset (a "**non-contributing partner**") in the same position they would have been in if the asset had been contributed with a tax basis equal to its fair market value.

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[11] Deficit Reduction Act of 1984, Pub. L. No 98-369, 98 Stat. 494. From 1954 until 1985, partnerships were permitted, but not required, to allocate items to take into account such disparities. *See* Sarah Brodie and Gary Huffman, *Is it Time to Remediate Code Sec. 704(c)?*, 103 Taxes 55 (Mar. 2025).

[12] Treas. Reg. § 1.704-3(a)(1) (first sentence).

[13] *See, e.g.*, Treas. Reg. § 1.704-3(a)(10).

[14] Treas. Reg. § 1.704-3(a)(1) (fifth sentence).

[15] The term "section 704(c) property" means property contributed to a partnership at a time when the fair market value of the property differs from the contributing partner's basis in the property. Treas. Reg. § 1.704-3(a)(3)(i). The regulatory definition focuses on the contributing partner's basis in the property at the time of the contribution, whereas the text of the Code focuses on the basis of the property in the hands of the partnership. In light of the carryover (or transferred) basis rule of section 723, there is no substantive difference between the two unless the contributor recognizes gain on the contribution by reason of section 721(b), which would eliminate all of the built-in gain in the contributed property.

[16] Treas. Reg. § 1.704-3(a)(1).

[17] *See* Treas. Reg. § 1.704-3(b), 1.704-3(c) and 1.704-3(d).

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Section 704(c) generally is applied on an asset-by-asset basis and not on an aggregate basis.[18] A partnership may use different methods with respect to different contributed assets, provided that a single reasonable method is applied to each asset and the overall method, or combination of methods, is reasonable based on the facts and circumstances and is consistent with the purposes of section 704(c).[19] The anti-abuse rule under Treas. Reg. § 1.704-3(a)(10) states that an allocation method, or combination of methods, is not reasonable if the contribution of property and the allocation of tax items with respect to the property are made with a view to shifting tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability.[20]

Under the traditional method, tax allocations to non-contributing partners with respect to section 704(c) property generally must, to the extent possible, equal their section 704(b) book allocations.[21] This means that if a partnership recognizes gain from the sale of section 704(c) property, the built-in gain or loss inherent in the property at the time of contribution must be allocated to the contributing partner, and, with respect to depreciable or amortizable property, the contributing partner bears the tax consequences of the built-in gain or loss with respect to the partnership's allocations of tax deductions arising from the section 704(c) property through special allocations of depreciation or amortization. Importantly, the total allocation of tax items with respect to a piece of property cannot exceed the partnership's total tax items from that property in that tax year. This rule is known as the "ceiling rule,"[22] and the limitation it poses is known as the "ceiling rule

[18] Treas. Reg. § 1.704-3(a)(2). The regulations permit aggregation in certain situations. Treas. Reg. § 1.704-3(e)(2) (relating to certain depreciable property, zero-basis property, and inventory) and -3(e)(3) (relating to securities partnerships).

[19] *Id*.

[20] This Report generally does not directly address any issues associated with the anti-abuse rule under Treas. Reg. § 1.704-3(a)(10). As a general matter, recommendations, discussion and examples in this Report assume that all relevant taxpayers are negotiating applicable allocations at arm's length and are U.S. taxable investors generally with adverse interests and does not address whether additional rules are necessary (or specific modifications to the anti-abuse rule under Treas. Reg. § 1.704-3(a)(10) are necessary) to address any other particular situations. We also note that commentators have previously criticized certain inadequacies of the anti-abuse rule at length. *See, e.g*., Sarah Brodie and Gary Huffman, *Is it Time to Remediate Code Sec. 704(c)?*, 103 Taxes 55 (Mar. 2025); Michael P. Spiro, *Castle Harbour Revisited: Application of the Code Sec. 704(c) Anti-Abuse Rule to Ceiling Rule Distortions*, Taxes (Oct. 2012); Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 Fla. L. Rev. 93 (1996).

[21] As used in the regulations under subchapter K and in this Report, the term "book" refers to the books of the partnership maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv). *See* Treas. Reg. § 1.704-3(a)(2)(i) (referencing Treas. Reg. § 1.704-1(b)(2)(iv) and requiring that, for purposes of making section 704(c) allocations, its principles be followed by partnerships that do not otherwise maintain books under that regulation).

[22] *See* Treas. Reg. § 1.704-3(b).

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limitation." As discussed in more detail in this Report, the ceiling rule can result in distortions between book and tax items for non-contributing partners.

Under the curative allocation method, a partnership is permitted to make reasonable curative allocations to eliminate distortions resulting from the ceiling rule. Specifically, a tax item can be allocated differently from its corresponding book item to compensate the non-contributing partner for allocation shortfalls of another tax item. In other words, this method permits a partnership to "borrow" tax items attributable to other properties,[23] though certain restrictions apply in determining whether curative allocations are reasonable.[24]

Lastly, under the remedial allocation method, the partnership is permitted to create, rather than borrow, a tax item and allocate it to a non-contributing partner to offset any distortions resulting from the ceiling rule. The partnership must then allocate an offsetting item to the contributing partner, such that, on an overall basis, the total net income or loss of the partnership is unaffected by the remedial allocations.

Section 704(c) principles apply not only to gain or loss inherent in contributed section 704(c) property ("**forward section 704(c)**" gain or loss) but also apply to differences between the property's book basis and adjusted tax basis that are created by reason of a revaluation of partnership property pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) ("**reverse section 704(c)**" gain or loss).[25]

This Report focuses on certain issues within the existing framework outlined in Treas. Reg. § 1.704-3 and does not address the question of whether there should be a substantial overhaul of those regulations.[26] The regulations under section 704(c) generally

[23] Treas. Reg. § 1.704-3(c)(1).

[24] *See* Treas. Reg. § 1.704-3(c)(3).

[25] Treas. Reg. § 1.704-3(a)(6)(i).

[26] The ceiling rule limitation under section 704(c), as created by Congress in 1954 and subsequently implemented by Treasury and the IRS in the "traditional method" under Treas. Reg. § 1.704-3(b), has been, and continues to be, criticized for causing permanent inside-outside basis disparities that are in direct tension with the anti-shifting policy goals of section 704(c). Specifically, commentators have repeatedly noted that the ceiling rule limitation results in permanent loss of cost recovery deductions for the non-contributing partner and benefits to the contributing partner from both a timing and a character perspective. The ceiling rule also has certain cascading effects on other sections of the Code. For example, a buyer's step-up in tax basis under Section 743(b) may not equal a seller's gain recognized in a taxable transaction when the ceiling rule applies. In 2021, Senator Ron Wyden released draft proposals to reform partnership tax, including a proposal to make remedial allocations mandatory for all section 704(c) allocations. The discussion of the motivations behind the proposal references the ceiling rule limitation and recognizes that remedial allocations generally would prevent the book-tax differences resulting from application of the ceiling rule. Commentators have also suggested other solutions, such as allowing contributing partners to enter into gain recognition agreements or adopting the deferred sale method discussed above. This Report does not revisit the current general framework of section 704(c). We assume for purposes of this Report that the current framework (which permits, subject to certain limits, a degree of taxpayer flexibility in applying section
(….continued)

are limited to relatively straightforward situations involving a single simple partnership, with only a few rules specific to tiered partnerships,[27] nonrecognition transactions (such as certain partnership mergers)[28] and other discrete issues. This has left tax practitioners in need of substantial guidance on the proper application of section 704(c) with respect to a variety of situations. This is especially true given the widespread and ever-increasing use of partnerships in diverse types of business operations and investment activities since the enactment of the Deficit Reduction Act of 1984. The IRS recognized this need more than 15 years ago when it issued Notice 2009-79,[29] which is the subject of a prior report submitted by the Tax Section on January 22, 2010 (the "**Prior Layers Report**").[30] In this Report, we reiterate the continued need for additional guidance under section 704(c) and provide Treasury and the IRS with recommendations on important topics to enhance the administration of section 704(c) for both the government and taxpayers.

IV. Topics and Recommendations for Guidance

This Part IV sets forth the description of, and our recommendations as to, the most critical issues under section 704(c) that are in need of guidance. As noted below, some of these recommendations were included in prior NYSBA Tax Section reports.

a. Nonrecognition transactions/substitute basis property (Treas. Reg. § 1.704-3(a)(8)(i))

Treas. Reg. § 1.704-3(a)(8)(i) provides rules for situations in which a partnership disposes of section 704(c) property in a nonrecognition transaction (the "**Substituted Property Rules**"). In those situations, the substituted basis property (within the meaning of section 7701(a)(42)[31]) is treated as section 704(c) property with the same amount of inherent gain or loss as the section 704(c) property disposed of by the partnership (subject to appropriate adjustments to the extent the gain or loss is recognized in the exchange).

704(c)(1)(A)) will be maintained. For critiques of the ceiling rule limitation and the overall framework of section 704(c), *see* Laura E. Cunningham, *Use and Abuse of Section 704(c)*, 3 Fla. L. Rev. 93 (1996); Leigh Osofsky, *Unwinding the Ceiling Rule*, 34 Va. Tax Rev. 63 (2014); Donald Turlington, *Section 704(c) and Partnership Book-Tax. Disparities, The Ceiling Rule and the Art of Tax Avoidance*, 46 Inst. on Fed. Tax'n § 26. (1988).

[27] *See* Treas. Reg. § 1.704-3(a)(9).

[28] *See* Treas. Reg. § 1.704-3(a)(8)(i).

[29] 2009-34 I.R.B. 255.

[30] *See* NYSBA Tax Section, Report No. 1202: "Report on the Request for Comments on section 704(c) Layers Relating to Partnership Mergers, Divisions and Tiered Partnerships" (Jan. 22, 2010).

[31] Use section 7701(a)(42), "**substituted basis property**" means property having a tax basis determined in whole or in part by reference to (i) the tax basis in the hands of the transferor or (ii) other property held at any time by the person for whom the tax basis is to be determined.

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i. Section 351 Exchanges

The Substituted Property Rule contains a special rule for a contribution of section 704(c) property to a corporation in an exchange qualifying under section 351:

> If a partnership transfers an item of section 704(c) property together with other property to a corporation under section 351, in order to preserve that item's built-in gain or loss, the basis in the stock received in exchange for the section 704(c) property is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership.

Although not discussed in the preamble to the 1992 Proposed Regulations or the 1993 Treasury regulations, we believe the intent of this rule is clear: to preserve each partner's inherent gain or loss in the exchanged section 704(c) property and reflect this inherent gain or loss in the stock received by the partnership. The mechanics of applying this special rule, however, are less clear, and taxpayers have identified at least two potential approaches, including the specific identification approach and the blended basis approach.

1. Specific Identification Approach

Under the specific identification approach, a partnership identifies and designates the specific shares that were received (or were properly treated for tax purposes as having been received) in exchange for the section 704(c) property contributed to the corporation. Under this approach, the partnership is treated as having contributed section 704(c) property to the corporation in exchange for specific, identifiable shares of stock, and each share has a basis equal to the partnership's basis in the property treated as having been contributed in exchange for that share. A literal reading of Treas. Reg. § 1.704-3(a)(8)(i) supports the specific identification approach: "the basis in the stock received in exchange for the section 704(c) property ***is determined as if each item of section 704(c) property had been the only property transferred to the corporation by the partnership***."[32] This specific identification approach has been permitted in other contexts in both case law[33] and in the language in the proposed regulations under section 358 that were subsequently

[32] Treas. Reg. § 1.704-3(a)(8)(i) (emphasis added).

[33] *See, e.g.*, *Brown v. Commissioner*, 27 T.C. 27 (1956) (certain partners' earlier contribution of some assets of the partnership to a corporation in exchange for stock, followed by the installment sale of the remainder of the partnership's assets to the corporation, was upheld as two separate transactions and not as a single nonrecognition transaction); *Monaghan v. Commissioner*, 40 T.C. 680 (1963) (a taxpayer's sale of his liquor business in two transactions to the same buyer, a sale of the inventory assets for cash and an installment sale of the non-inventory assets was upheld as two separate transactions); *Collins v. Commissioner*, 48 T.C. 45 (1962) (a taxpayer's sale of approximately 53 acres to the same buyer in two parts, the sale of a 19.67 acre parcel for cash and the installment sale of the remaining acres, was upheld as two separate transactions).

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withdrawn, which applies certain basis tracing rules to transfers of stock in certain section 351 transactions that do not qualify as reorganizations.[34]

> **Example 1**. X contributes Asset with an adjusted basis of $30 and fair market value of $100 to LLC,[35] and Y contributes $100 of cash to LLC. They are equal members in LLC. Later, when value and basis have not changed, LLC contributes Asset and the cash to A, a corporation, in exchange for two shares of A common stock in a transaction qualifying under section 351(a).
>
> Under the specific identification approach, LLC identifies one of the shares of A stock as being received in exchange for Asset and the other as being received in exchange for the cash. Thus, one share is substituted basis property that has a tax basis of $30 and fair market value of $100, and the other share is not substituted basis property and has a basis and value of $100.

The specific identification approach allows certain other rules applicable to partnerships, such as the "anti-mixing bowl" rules,[36] to be applied more easily in practice, as taxpayers and the IRS have certainty regarding which specific shares are subject to section 704(c)(1)(A) (and, therefore, sections 704(c)(1)(B) and 737).

> **Example 2**. The facts are the same as in Example 1. After the contribution to A, and within seven years of X's contribution of Asset to LLC, LLC liquidates, distributing the share of A stock that is substituted basis property to X and the other share to Y. Because X is receiving the property it is treated as having contributed (and no other property) under the Substituted Property Rules, neither section 704(c)(1)(B) nor section 737 applies to the distribution.[37]

The application of the specific identification approach can be impractical, however, if the partnership receives a number of shares that is not easily divisible based on the relative fair market values of the properties contributed to the corporation, as demonstrated by Example 3 below, or if the partnership receives fewer shares than the number of properties contributed.

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[34] REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009), *as amended by* 74 Fed. Reg. 9575 (Mar. 5, 2009).

[35] In this Report, unless noted otherwise, every entity described as a partnership or limited liability company (or LLC) is classified as a partnership for U.S. federal income tax purposes.

[36] Sections 704(c)(1)(B) and 737.

[37] There are numerous exceptions to gain recognition under sections 704(c)(1)(B) and 737. In all cases, however, if the contributor receives all of its contributed property (or successor contributed property), neither section 704(c)(1)(B) nor 737 causes gain recognition.

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> **Example 3**. The facts are the same as in Example 2, except that LLC receives only one share of stock in A in the contribution. In this case, it is not clear how the specific identification approach should be applied.

Treasury endorsed the specific identification approach in a private letter ruling in 2015. In PLR 201505001, the IRS applied the specific identification approach to section 704(c) property contributed by a partnership to a corporation in a section 351 exchange. Under Treas. Reg. § 1.704-3(a)(8)(i), the partnership was deemed to make two contributions to the corporation. First, the partnership was deemed to contribute each section 704(c) property to the corporation in exchange for the shares treated as the successor 704(c) property with the same inherent gain or loss as the contributed section 704(c) property. The IRS noted that the first contribution "preserve[d] the built-in gain or loss attributable to [the partnership's] section 704(c) property with respect to [its partners]." Second, the partnership was deemed to contribute the rest of its property in exchange for the rest of the stock of the corporation.

Two primary concerns with the specific identification approach are as follows: First, because the specific identification approach in some circumstances permits taxpayers to specifically identify (or, more derisively, "cherry-pick") shares that are involved in later transactions, it could in some circumstances make it easier for a partnership to choose whether and when to recognize section 704(c) gain or loss by selling the substituted basis shares before selling other shares. Relatedly, because the "anti-mixing bowl" rules build off of the basic rules of section 704(c)(1)(A), specific identification permits taxpayers to avoid the application of the anti-mixing bowl rules by carefully selecting which shares are distributed to which partner. Second, the specific identification approach could also be seen as inconsistent with the IRS's position in Rev. Rul. 85-164[38] that an exchange subject to section 351 results in a blended basis in the stock received.[39]

[38] Rev. Rul. 85-164, 1985 CB 117.

[39] In Rev. Rul. 85-164, an individual contributed all of the assets of a sole proprietorship to a new corporation in exchange for stock and securities of the corporation. The taxpayer, intending for the high basis and long-term holding period of the capital assets contributed to carry over to the securities received in the exchange, designated specific property to be exchanged for particular stock and securities. The IRS ruled that the individual had to allocate its aggregate tax basis in the contributed property across all of the stock and securities received in proportion to the fair market values of each class, thus resulting in the taxpayer holding each class of stock or securities received with a blended tax basis.

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2. *Blended Basis Approach*

Under the blended basis approach, a partnership treats each share as having been received in part for each item of section 704(c) property contributed to the corporation and in part for any other property contributed to the corporation in the section 351 exchange, such that each share is bifurcated into separate components, each with its own fair market value and basis. The blended basis approach is informed by the IRS's approach in Rev. Rul. 85-164.[40]

The blended basis approach is particularly attractive in situations in which the specific identification approach is impractical (such as when a partnership receives fewer shares than the number of properties contributed), as it embeds each partner's ratable share of 704(c) gain or loss into each share received by the partnership. Furthermore, in situations in which liabilities are assumed in connection with a contribution of both section 704(c) property and other property in a section 351 exchange, the blended basis approach allows for simpler coordination with, and application of, section 357.[41] Moreover, the blended basis approach alleviates burdens on the partnership associated with tracking the specific shares that are successor 704(c) property (because <u>all</u> shares are in part successor property), although it does make the anti-mixing bowl rules more likely to apply, adding complexity and the potential for the inappropriate acceleration of gains and losses.

One key issue with the blended basis approach is that, depending on the mix of assets contributed to the corporation in the section 351 exchange, the blended basis approach can reduce (or even eliminate) the section 704(c) gain.

> **Example 4**. The facts are the same as in Example 1, except that LLC uses the cash contributed by Y to buy Property for \$100. Later, when the value of Property decreases to \$30 and its basis is unchanged, and the value and basis of Asset remains the same (i.e., \$100 and \$30, respectively), LLC contributes Asset and Property to B, a corporation, in exchange for one share of the corporation's common stock in a transaction qualifying under section 351(a).
>
> Under the blended basis approach, LLC treats the share of common stock as having been received in part for Asset and in part for Property and holds the share of common stock with a basis of \$130 and a fair market value of

[40] *See also* Generic Legal Advice Memorandum 2020-005 (May 22, 2020) (a shareholder's stock in a corporation has a split basis and a split holding period reflecting both the initial tax-free contribution of negligible value to such corporation in exchange for stock of such corporation and the subsequent tax-free contribution of additional property in exchange for no stock).

[41] *See* NYSBA Tax Section, "Report on Proposed Regulations Regarding Allocation of Basis Under Section 358" (May 27, 2005) for a detailed discussion of the challenges associated with coordinating the application of section 357 with a specific identification approach.

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$130.[42] X, however, would still have a $70 built-in tax gain in its interest in LLC, and B would have a $70 built-in tax gain in Asset and a $70 built-in tax loss in Property.

A key difference between the specific identification approach and the blended basis approach is with respect to dispositions of only a portion of the shares received by a partnership in a section 351 exchange (or a partially taxable disposition of all of the shares).[43] As noted above, under the specific identification approach, a partnership is required (or permitted) to designate the shares exchanged. Under the blended basis approach, on the other hand, taxpayers would not be required or permitted to designate specific shares for sales or distribution, as the tax attributes of each share would be identical.[44]

As noted above, a literal reading of the Substituted Property Rules would require using the specific identification approach. Moreover, the blended basis approach clashes with general section 704(c) principles. Treas. Reg. § 1.704-3(a)(2) provides that "section 704(c) and this section apply on a property-by-property basis. Therefore, ***in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated.***"[45] This general tenet of operation with respect to section 704(c) could be understood to preclude the use of the blended basis approach.

As compared with the blended basis approach, the specific identification approach is more consistent with the literal text of the regulations and more likely to track gains and losses associated with section 704(c) property accurately, but it entails meaningful administrative complexity and has certain other disadvantages noted above. We also note that other approaches exist to allocate basis to the share(s) of stock received in section 351 exchanges, including hybrids of the specific identification approach and the blended basis

[42] *See* Jennifer A. Ray, *Dividing the Indivisible: Identifying the "Property" in Partnership Transactions*, The Tax Magazine (Feb. 11, 2022) for an additional discussion and additional examples on the differences between the specific identification approach and the blended basis approach. The result in Example 4 is among the reasons that commentators have observed that the blended basis approach could be viewed as rendering Treas. Reg. § 1.704-3(a)(8)(i) inoperative in a manner that is inconsistent with the words of the rule itself.

[43] In some instances, if the partnership disposed of all of the shares received in the section 351 exchange in a fully taxable exchange, the specific identification and blended basis approach may reach the same tax result.

[44] *See, e.g.*, Jennifer A. Ray, *Dividing the Indivisible: Identifying the "Property" in Partnership Transactions*, The Tax Magazine (Feb. 11, 2022).

[45] Treas. Reg. § 1.704-3(a)(2) (emphasis added). Treas. Reg. § 1.704-3(e)(2) and Treas. Reg. § 1.704-3(e)(3) provide limited situations in which specific property (depreciable property, zero-basis property, and inventory), or a securities partnership with respect to reverse section 704(c) allocations from qualified financial assets, may be aggregated for purposes of making allocations under section 704(c).

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approach and could be considered.[46] Any of these approaches has benefits and disadvantages, and we are not recommending requiring a particular approach. We recommend instead that Treas. Reg. § 1.704-3(a)(8)(i) be amended to provide a clear rule on the approach taxpayers may (or must) use to allocate basis to the share(s) of stock received in section 351 exchanges, subject to the application of the reasonableness requirement of Treas. Reg. § 1.704-3(a)(1). Moreover, if the specific identification approach is required, we recommend that Treasury and the IRS provide additional guidance on how the specific identification approach applies to particular situations, including those involving a partial disposition.

ii. Multiple Pieces of Substituted Basis Property – Tiered Partnerships

Tiered partnerships add a layer of complexity to section 704(c) (and nearly every other part of subchapter K),[47] perhaps the most commonly encountered of which is the allocation of section 704(c) amounts among multiple assets received in a nonrecognition exchange. A common situation in which this is encountered is a distribution of property by an LTP to a UTP when the LTP interest held by UTP is section 704(c) property. The issue is best understood by example:

> **Example 5**. X contributes $30 in cash to LTP in exchange for an interest in LTP. Later, when X's basis in LTP remains $30 and the fair market value of the interest is $100, X contributes the LTP interest to UTP. The LTP interest is section 704(c) property.
>
> Later, when UTP's basis in LTP remains $30 but the fair market value of the LTP interest is $400, LTP distributes Asset 1 (which was acquired by LTP with cash in an unrelated transaction) with a $10 basis and a fair market value of $150 to UTP in partial redemption of UTP's interest in LTP. Under section 731, neither LTP nor UTP recognizes gain or loss on the distribution. UTP takes Asset 1 distributed by LTP with a $10 basis under section 732(a).

It is relatively clear that under the Substituted Property Rule the section 704(c) gain with respect to LTP is required to be allocated as between the LTP interest and the distributed property because the section 731 distribution is a nonrecognition transaction in which UTP disposes of a portion of its interest in LTP. Similarly, we believe it is clear that UTP is required to use the same section 704(c) method with respect to any section 704(c) gain that is allocated to the distributed property that it is using with respect to its interest in

[46] For example, one such hybrid approach could be for Treasury and the IRS to generally require the use of the blended basis approach but to permit the use of the specific identification approach in those situations that Treasury and the IRS deem non-abusive.

[47] *See* Gary R. Huffman and Barksdale Hortenstine, *Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships*, 86 Tax 197 (Mar. 2008), which covers many important issues relating to tiered partnerships.

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LTP. However, there is no guidance that addresses the appropriate method of allocation of the section 704(c) gain as between the LTP interest and the distributed property. It is intuitively appealing to take a mathematical approach, which may appear "neutral" to some, and allocate the section 704(c) gain in proportion to the relative fair market values of the distributed asset and the remaining LTP interest. In this example, distributed Asset 1 has a fair market value of $150, while UTP's remaining LTP interest has a fair market value of $250 ($400 - $150). Therefore, under this mathematical approach, Asset 1 would have $26.25 of section 704(c) gain (37.5%), while the section 704(c) gain in UTP's LTP interest is reduced to $43.75 (62.5%). While this approach creates tension between each asset's section 704(c) amount and its inherent tax gain (as the section 704(c) amount would not bear any relation to the inherent tax gain), it would be consistent with a literal reading of the Substituted Property Rule, which requires that the successor property be treated as section 704(c) property "***with the same amount of built-in gain or loss as the section 704(c) property disposed of by the partnership.***"[48, 49] Moreover, this approach would be relatively simple to apply in a situation where any partnership either partially disposes of section 704(c) property in a nonrecognition transaction or disposes of section 704(c) property in a nonrecognition transaction for multiple properties (as the partnership would be able to allocate the section 704(c) amount between the properties received based on their fair market values).

Alternatively, the section 704(c) gain could be allocated in proportion to the relative tax bases of the distributed asset and the remaining LTP interest. In this case, 1/3 of the section 704(c) gain would be allocated to Asset 1, while 2/3 of the section 704(c) gain would be allocated to UTP's remaining LTP interest.[50]

A further approach would be to allocate the section 704(c) gain by prorating it in proportion to the relative inherent tax gain in the distributed asset and the remaining LTP interest immediately after the distribution. Applying this approach to Example 5, the distributed asset has an inherent tax gain of $140, while the remaining LTP interest has an inherent tax gain of $220. As such, the inherent tax gain in the distributed asset represents 38.89% of UTP's total tax gain inherent in the distributed asset and the LTP interest, and the inherent tax gain in the LTP interest represents 61.11% of UTP's total inherent tax gain.

[48] Treas. Reg. § 1.704-3(a)(8)(i).

[49] The total amount of section 704(c) gain should be the same before and after the allocation. In Example 5, if Asset 1 were sold immediately after the distribution, there is enough inherent tax gain in Asset 1 and the remaining LTP interest such that there is no elimination of section 704(c) gain. Specifically, Asset 1 has an inherent tax gain of $140 ($150 - $10), while the remaining LTP interest has an inherent tax gain of $220 ($250 - $30). Because Asset 1 has $26.25 of section 704(c) gain and the remaining LTP interest has $43.75 of section 704(c) gain, there would be no elimination of section 704(c) gain. If, however, the value of the LTP interest were to decline after being contributed to UTP, there may not be sufficient inherent tax gain upon such a sale regardless of the manner in which the section 704(c) gain is allocated between Asset 1 and the remaining LTP interest. The lack of sufficient tax gain is a consequence of the ceiling rule limitation. *See* footnote 26.

[50] The tax basis of Asset 1 is $10 and the remaining LTP interest has a tax basis of $20 ($30 - $10). As such, the relative tax bases of Asset 1 and the remaining LTP interest are 1/3 and 2/3.

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Therefore, the distributed asset would be treated as having $27.23 of section 704(c) gain, while the section 704(c) gain in UTP's LTP interest would be reduced to $42.77. Finally, it could be permissible to allocate the section 704(c) gain in any manner as long as all of the gain is accounted for, subject to the application of the reasonableness requirement of Treas. Reg. § 1.704-3(a)(1).[51]

Similar questions arise on a distribution of multiple assets (whether or not in a liquidating distribution).[52]

Given the lack of guidance on the apportionment of section 704(c) amounts in partial dispositions of section 704(c) property in nonrecognition transactions, we recommend clarifying Treas. Reg. § 1.704-3(a)(8)(i) to provide guidance regarding appropriate apportionment mechanics for partial dispositions of section 704(c) property. In particular, we recommend that the taxpayers should be permitted to use any reasonable allocation method, subject to the application of the reasonableness requirement of Treas. Reg. § 1.704-3(a)(1), to ensure that the selected method not have a principal purpose of substantially reducing the net present value of the partners' aggregate tax liability by shifting gain among the partners.

b. Transfers of partnership interests (Treas. Reg. § 1.704-3(a)(7))

The first sentence of Treas. Reg. § 1.704-3(a)(7) provides that if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. Stated differently, the transferee steps into the shoes of the transferor for purposes of section 704(c). Importantly, the second sentence of Treas. Reg. § 1.704-3(a)(7) provides that if a contributing partner transfers *a portion* of the partnership interest, the share of built-in gain or loss *proportionate to* the interest transferred must be allocated to the transferee partner. That is, the transferee steps into a portion of the shoes of the transferor. Precisely what that "portion" is remains unclear more than 30 years after the rule was added to the regulations, although it is understood by many to refer to "proportionate" in the common mathematical sense. In the simplest of fact patterns, that interpretation of the rule makes sense, but in many situations it does not.

Example 6. X contributes Asset 1 with a basis of $40 and value of $100, and Y contributes $100 of cash, to LLC; they are equal members of LLC.

[51] If no specific allocation method is prescribed and taxpayers are permitted to use any reasonable method, Treasury and the IRS may want to consider providing that it is not reasonable to allocate section 704(c) gain to an asset that does not have any built-in gain or to an asset in an amount in excess of the asset's built-in gain unless, in either case, there is no other asset with sufficient built-in gain to which section 704(c) gain can be allocated.

[52] The interaction between section 743(b) and section 704(c) within tiered partnerships also raises interesting issues that are not discussed in this Report. *See* Gary R. Huffman and Barksdale Hortenstine, *Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships*, 86 Tax 197 (Mar. 2008) for a discussion of this (and other) issues involving tiered partnerships.

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Later, when values and bases remain unchanged, X sells 1/3 of its interest to Z (resulting in Z's holding a 16.67 percent interest in LLC).[53]

Under the second sentence of Treas. Reg. § 1.704-3(a)(7), Z succeeds to 1/3 of the section 704(c) gain in Asset 1. Thus, if LLC sells Asset 1 for $100, LLC does not recognize any section 704(b) book gain or loss, and the $60 of tax gain is allocated 2/3 to X and 1/3 to Z (or $40 to X and $20 to Z).

If, instead, LLC sells Asset 1 for $130, the $30 of book gain is allocated $10 to X, $15 to Y, and $5 to Z.[54] The $90 of tax gain is allocated $50 to X, $15 to Y, and $25 to Z.[55]

The application of the rule is unclear, however, in a wide array of common situations, such as when a partner transfers a portion of a leveraged interest and the debt does not shift to the transferee under section 752 in connection with the transaction.

Example 7.[56] P is the common parent of a consolidated group, and S1 and S2 are members of that group. P and S1 form LLC. P contributes Asset 1 with a $0 basis and $1,000 value to LLC. In exchange, P receives 100 units in LLC and a debt-financed distribution of $900. P guarantees repayment of the $900 borrowing by LLC.[57] S1 contributes $10 of cash to LLC in exchange for 10 units.

P transfers 95 units to S2. Because of P's guarantee of LLC's borrowing, the entire liability is allocated to P both before and after the transfer of the 95 units to S2. The parties take the position that, under Treas. Reg. § 1.704-3(a)(7), S2 succeeds to 95 percent, or $950, of P's section 704(c) gain in Asset 1.

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[53] LLC does not have a section 754 election in effect for the year that includes the date of Z's purchase of its interest in LLC.

[54] X has a 33.33 percent interest in the partnership, so X is allocated 33.33 percent of the $30 gain, which is $10. Y has a 50 percent interest in the partnership and therefore is allocated 50 percent of the $30 gain, which is $15. Z has a 16.67 percent interest in the partnership and therefore is allocated 16.67 percent of the $30 gain, which is $5.

[55] The section 704(c) gain of $60 is shared proportionately by X and Y. X is allocated 2/3 of that gain (or $40) and Y is allocated 1/3 of that gain (or $20). The remaining $30 gain is shared based on the partner's interests in the partnership and aligns with the allocation of book gain: X is allocated 33.33 percent of that gain ($10), Y is allocated 50 percent of that gain ($15) and Z is allocated 16.67 percent of that gain ($5).

[56] The example is based on a transaction reported to have been entered into by Enron Corporation. *See* Staff of the Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (Feb. 2003).

[57] The distribution does not give rise to a disguised sale by P to LLC because the liability is allocated to P under Treas. Reg. § 1.752-2. *See* Treas. Reg. § 1.707-5(b).

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LLC sells Asset 1 for $1,000, recognizing no section 704(b) book gain or loss, but recognizing $1,000 of taxable gain. LLC allocates the taxable gain $50 to P and $950 to S2. This causes P's outside basis to increase from $0 to $50. Although P's LLC interest is worth only $5, P's share of LLC's liabilities is $900, meaning that P would recognize $905 of gain if it disposed of the interest.[58] With a bit of care, however, the gain in P's interest can be deferred, perhaps permanently.

The allocation to S2, on the other hand, causes S2's basis to increase from $0 to $950. Because the interest is worth only $95, S2 would recognize an $855 loss if it disposed of the interest. (Alternatively, LLC could distribute $95 worth of depreciable property to S2; S2 would take a $950 basis in the property under section 732(b) and depreciate the property.)[59]

As can be seen from Example 7, although a strictly mathematical approach to the application of Treas. Reg. § 1.704-3(a)(7) has the appeal of simplicity, it can create inside-outside basis disparities.[60]

Similar uncertainties (and issues) arise in situations in which a transferor partner holds both a common and a preferred interest.

Example 8. X contributes nondepreciable Asset 1 with a basis of $40 and value of $100 to LLC in exchange for a $90 preferred interest and a 9 percent common interest. Y contributes $100 of cash to LLC in exchange for a 91 percent common interest. LLC invests the contributed cash in Asset 2. Later, when X's preferred interest is still worth $90, X's common interest is worth $810 and asset basis remains unchanged, X sells a $30 preferred interest (1/3 of the preferred interest) to Z for $30.[61]

If "proportionate" means proportionate to total value, then 3.33 percent ($30 value of preferred interest transferred/$900 value of X's total interest in

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[58] The amount realized would equal $950 debt relief under section 752(d) plus $5 cash received. Gain realized and recognized would equal $955 less $50 outside basis.

[59] Since 2004, section 734(b) would require a negative adjustment to be made to the basis of LLC's remaining property if the increase under section 732(b) to the basis of the property distributed by LLC to S2 were more than $250,000. At the time Enron Corporation is reported to have entered into the transaction, however, basis adjustments under section 734(b) were entirely optional.

[60] An inside-outside disparity arises when a partner's outside basis differs from its share of the basis of partnership property (which generally can be calculated under the principles of Treas. Reg. § 1.743-1). Put more simply (or differently), an inside-outside disparity or difference can be seen when the gain or loss that a partner would recognize on the taxable disposition of its interest differs from the gain or loss that would be allocated to the partner if the partnership were to sell all of its property and allocate the resulting gains and losses to its partners.

[61] LLC does not have a section 754 election in effect for the year that includes the date of Z's purchase of its interest in LLC.

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LLC) of the section 704(c) gain transfers to Z. In that case, if, after Z's purchase, LLC were to sell Asset 1, the first $60 of taxable gain would be allocable to X and Z under section 704(c)(1)(A). X would be allocated $58 of gain (96.77 percent of $60), and Z would be allocated $2 of gain (3.33 percent of $60).

If, on the sale of its interest to Z, X allocated its $40 outside basis in proportion to the relative values of the interest retained and the interest sold,[62] X's basis in its retained interest would be $39.[63] The allocation of $58 of section 704(c) gain to X would increase its outside basis in its retained interest to $97. This would cause X's gain in its LLC interest to be $773 (the excess of the fair market value of the retained interest, $870,[64] over the $97 outside basis); X's share of inside gain is $858.[65]

The result in Example 8 further demonstrates the shortcomings of a purely mathematical approach to Treas. Reg. § 1.704-3(a)(7).

To address these and similar situations, we recommend that Treas. Reg. § 1.704-3(a)(7) be amended to provide that the transferee partner inherits a share of the transferor's built-in gain or loss that is "attributable," rather than "proportionate," to the interest that is

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[62] It is not clear how much of X's basis is allocated to the portion of its interest that it sold to Z. Rev. Rul. 84-53, 1984-1 C.B. 159 addresses the sale of a portion of a partnership interest. The ruling correctly holds that a partner has only one interest in a partnership. The ruling correctly cites to Treas. Reg. § 1.61-6 for the proposition that when a portion of a piece of property is sold, the seller is required to equitably apportion its basis in the property between the interest retained and the interest sold. An example in the regulation apportions basis based on relative fair market values of the interest retained and the interest sold. The ruling is often misinterpreted as standing for the proposition that equitable apportionment requires an allocation of basis based on relative fair market values. Such an apportionment is not required by the regulation, and there are surely numerous situations in which such an apportionment would be inequitable and, therefore, inappropriate. One such situation is Situation 4 of Rev. Rul. 84-53, in which the partner's share of partnership liabilities exceeds its basis in its partnership interest. Not surprisingly, the holding in that situation does not apportion outside basis in proportion to relative values.

[63] The retained interest is 97.66 percent of the total interest, and 97.66 percent of $40 is $39.

[64] X's common interest is worth $810, and its retained preferred interest is worth $60, resulting in the value of its total retained interest equaling $870.

[65] X's share of inside gain is calculated as follows: X's 9 percent common interest is worth $810, meaning Y's 91 percent common interest is worth $8,190. Total common interests are therefore worth $9,000, and the value of all interests (and therefore of all assets of the LLC, given the LLC has no liabilities) is worth $9,090 ($9,000 common + $90 preferred). Asset 1 is worth $100, and therefore Asset 2 is worth $8,990 ($9,090 - $100). As noted above, X has $58 of forward 704(c) gain in respect of Asset 1. Asset 2 has a basis of $100 and therefore there is a total of $8,890 of gain in respect of Asset 2. X's share of that gain is $800 (9% of $8,890). Therefore, X's share of inside gain is $858 ($58 in respect of Asset 1 and $800 in respect of Asset 2).

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transferred.[66] The meaning of the term "proportionate" in this context is unclear, and proportionality is irrelevant, as that amount corresponds to neither the transferee's economic interest in the partnership nor its underlying assets and disregards entirely the necessary correspondence between inside and outside basis. Notably, this change would harmonize this rule with the capital accounting rules under Treas. Reg. § 1.704-1(b)(2)(iv), specifically Treas. Reg. § 1.704-1(b)(2)(iv)(l).[67]

c. Layers

As discussed above, section 704(c) principles apply not only to contributed, or "forward," section 704(c) amounts, but also to "reverse" section 704(c) gains and losses, which are section 704(c) amounts created in connection with the revaluation of partnership property under Treas. Reg. § 1.704-1(b)(2)(iv)(f).[68] A particular property can therefore have a forward section 704(c) amount and one or more reverse section 704(c) amounts. These amounts are referred to colloquially as "layers." Partnerships are not required to use the same allocation method for reverse section 704(c) layers as for forward layers, nor are they required to use the same allocation method for each reverse section 704(c) layer.[69]

In Notice 2009-70, Treasury and the IRS asked for comments on how certain tax items should be allocated among the different section 704(c) layers in various situations. The Prior Layers Report provided thirteen principal recommendations with respect to the proper allocation methods for section 704(c) layers in the context of single partnerships, tiered partnerships, mergers and divisions. We generally do not revisit the issues raised in the Prior Layers Report in this Report, and we instead refer readers to the Prior Layers Report. However, we would note that in the Prior Layers Report we included the following recommendation:

Partnerships generally should be required to maintain section 704(c) layers following a revaluation of property and should not be permitted to net offsetting layers following any such event. That said, in light of the complexity created by requiring partnerships to track section 704(c) layers, there should be an exception from such a layering requirement if the partnership's gross asset value is below a threshold amount, or if the asset(s) for which a section 704(c) layer would be maintained have a value below a

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[66] Sheldon I. Banoff, *Mr. Popeil Pushes Partial Partnership Interests through the Veg-o-Matic: You Can Slice 'Em, You Can Dice 'Em, but How Do You Tax 'Em?*, 72 Taxes 833 (December 1994).

[67] As previously noted in Report 1314, the "attributable to" approach is more consistent with the construct that a transferee has acquired the allocable portion of the assets of the partnership. NYSBA Tax Section, "Report on the Proposed Regulations on Partnership Built-In Losses" (Dec. 15, 2014).

[68] Treas. Reg. § 1.704-3(a)(6).

[69] Treas. Reg. § 1.704-3(a)(6)(i).

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lower threshold amount, or in the case of adjustments of less than a specified percentage of the partnership's carrying value of its aggregate assets.[70]

Although we believe the sounder approach is to generally require the creation and maintenance of separate layers, since the Prior Layers Report we have become increasingly aware of and sensitive to the amount of complexity and compliance costs involved in tracking section 704(c) layers. This complexity and cost are in many cases unnecessarily burdensome for smaller partnerships that do not have sufficient financial and human resources to maintain technical accuracy. As such, we reiterate the exemption for partnerships that are below two value-based thresholds. The first is an overall threshold based on the partnership's gross asset value, and that is set initially at $30 million. The second threshold is on an asset-by-asset basis and exempts separate layers for any asset with a value that is less than $1.5 million.[71] Both of these values should be subject to periodic adjustments to reflect inflation.

d. Tiers

Treas. Reg. § 1.704-3(a)(9), one of only two rules under section 704(c) specifically applicable to tiered partnerships, provides that when a UTP receives a contribution of either (i) section 704(c) property that the UTP subsequently contributes to an LTP or (ii) an interest in an LTP that holds section 704(c) property, the UTP must allocate its distributive share of items attributable to such section 704(c) property in a manner that takes into account the contributing partner's remaining built-in gain or loss in the section 704(c) property. Certain aspects of the operation of this rule are not entirely clear.[72,73]

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[70] Since the date of the Prior Layers Report, proposed Treasury regulations were issued under section 751(b) that specifically addressed section 704(c) layers. Notwithstanding these proposed regulations, our recommendation still applies. REG-151416-06, 79 Fed. Reg. 65,151 (Nov. 3, 2014), *as amended by* 80 Fed. Reg. 3926 (Jan. 26, 2015).

[71] These are the amounts recommended in the Prior Layers Report but have been adjusted for inflation.

[72] Although not specifically required under the regulations, an LTP needs to separately state such items for both book and tax purposes in order to permit the UTP to properly apply Treas. Reg. § 1.704-3(a)(9).

[73] Under Treas. Reg. § 1.704-1(b)(2)(iv)(q) (the "**q rule**"), which governs section 704(b) allocations where specific guidance is not otherwise provided under Treas. Reg. § 1.704-1(b)(2)(iv), capital accounts will not be considered to be determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv) unless capital account adjustments are made in a manner that (i) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership's balance sheet, as computed for book purposes, (ii) is consistent with the underlying economic arrangement of the partners and (iii) is based, wherever practicable, on federal tax accounting principles. Despite the reference to the q rule in Treas. Reg. § 1.704-3(a)(9), it is not altogether clear how it should be applied specifically to tax allocations under section 704(c) (as opposed to book allocations under section 704(b)).

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Example 9.[74] X contributes a machine with a tax basis of $60 and a fair market value of $100 to UTP. The machine is depreciable over five years on a straight-line basis. Y contributes land with a tax basis and fair market value of $100. X and Y are equal members of UTP. UTP adopts the traditional method of making section 704(c) allocations with respect to the machine.

Immediately after X contributes the machine to UTP, UTP contributes the machine to LTP, and Z contributes land to LTP that has a tax basis and fair market value of $100. UTP and Z are equal members of LTP. LTP adopts the traditional method of making section 704(c) allocations with respect to the machine.

Each year, LTP's book depreciation from the machine is $20 ($100 / 5) and its tax depreciation is $12 ($60 / 5). The book depreciation is allocated $10 to each of Z and UTP. The tax depreciation is allocated $10 to Z and $2 to UTP.[75] UTP, in turn, allocates the $10 of book depreciation equally to X and Y. Under Treas. Reg. § 1.704-3(a)(9), however, UTP is required to allocate its entire $2 of tax depreciation to Y (i.e., in a manner that takes into account X's remaining built-in gain or loss). The initial book capital account and tax basis of X and Y for the first five years are as follows:

The LTP:

	UTP		Z	
	Book	Tax	Book	Tax
Opening	100	60	100	100
Year 1	(10)	(2)	(10)	(10)
Year 2	(10)	(2)	(10)	(10)
Year 3	(10)	(2)	(10)	(10)
Year 4	(10)	(2)	(10)	(10)
Year 5	(10)	(2)	(10)	(10)
	50	**50**	**50**	**50**

[74] This example is drawn from Huffman and Hortenstine, *Tiers in Your Eyes: Peeling Back the Layers on Tiered Partnerships*, 86 Taxes 197 (Mar. 2008).

[75] Under the traditional method, tax allocations to non-contributing partners of cost-recovery deductions with respect to section 704(c) property must generally, to the extent possible, equal the book allocations to those partners. Treas. Reg. § 1.704-3(b).

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The UTP:

	X		Y	
	Book	Tax	Book	Tax
Opening	100	60	100	100
Year 1	(5)	—	(5)	(2)
Year 2	(5)	—	(5)	(2)
Year 3	(5)	—	(5)	(2)
Year 4	(5)	—	(5)	(2)
Year 5	(5)	—	(5)	(2)
	75	**60**	**75**	**90**

In Year 5, Y ends up with a $15 distortion, the difference between Y's book capital account of $75 and its tax basis of $90, even though the section 704(c) property (i.e., the machine) had enough basis for Y (the non-contributing partner) to have received tax depreciation equal to book depreciation if the machine had not been contributed to LTP.

It generally is understood that, if UTP had used a curative allocation method or the remedial allocation method, UTP could have addressed the ceiling rule limitation shown in Example 9. For instance, if UTP had used a curative allocation method, then each year it could have allocated to Y $3 of depreciation (from another asset) otherwise allocable to X; in that case, at the end of Year 5, Y's book and tax basis capital accounts would have equaled $75, consistent with the purpose of section 704(c).[76]

Concern has been expressed, however, that Treas. Reg. § 1.704-3(a)(9) as currently drafted may not permit the use of a curative allocation method or the remedial allocation method in such a situation on the theory that the depreciation allocated by LTP to UTP is not properly treated as an item to which section 704(c) applies because section 704(c) applies only to "basis derivative" items,[77] and depreciation allocated by LTP to UTP is not derived by UTP's basis in its LTP interest. Such a reading could lead to distortions that are at odds with the purpose of section 704(c) and Treas. Reg. § 1.704-3(a)(9). We do not believe this reading is compelled by the text of the regulation. Moreover, the legislative

[76] This approach has been referred to by practitioners as "re-remediation," even if a curative allocation method is used.

[77] The issue of basis derivative items is discussed further in Part K. For a discussion on the general nature of basis derivative items, *see* Eric Sloan, Katie Fuehrmeyer, and Jennfier Ray, 712-4th T.M., *Partnerships – Taxable Income; Allocation of Distributive Shares; Capital Accounts*.

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history indicates that items similar to section 704(c) property could be treated as section 704(c) property, which arguably includes items allocated by LTP to UTP.[78] In addition, the use of a curative method or the remedial allocation method to limit or eliminate the ceiling rule limitation created by reason of a tiered partnership structure strikes us as a "reasonable method" within the meaning of Treas. Reg. § 1.704-3(a)(1). We therefore recommend that Treas. Reg. § 1.704-3(a)(9) be amended to clarify that this approach is permitted under the regulations.

There similarly is uncertainty regarding the situations in which the principles of Treas. Reg. § 1.704-3(a)(9) may be applied. That is, is not clear whether application of the principles is limited to the situations described in Treas. Reg. § 1.704-3(a)(9) (the contribution of section 704(c) property to a UTP followed by the UTP's contribution of that property to an LTP, or the contribution of section 704(c) property to an LTP followed by the contribution of the interest to a UTP). But there are other situations that present precisely the same issue that is addressed by the regulation and to which the regulation (or its principles) ought to apply, one of which is illustrated by the following example:

> **Example 10**. X and Z each contribute $50 to LTP in exchange for a 50 percent interest in LTP. LTP purchases a machine for $100, which instantly doubles in value to $200. X then contributes its interest in LTP to UTP in exchange for a 50 percent interest UTP, and Y contributes $100 to UTP in exchange for a 50 percent interest in UTP.

As a purely textual matter, there is no section 704(c) property to which Treas. Reg. § 1.704-3(a)(9) applies. That is, there was no contribution of section 704(c) property to LTP that was followed by a contribution of the LTP interest to UTP. (Nor was there a contribution of section 704(c) property to UTP that UTP contributed to LTP.) Nonetheless, it would be consistent with the policy of section 704(c), as evidenced by Treas. Reg. § 1.704-3(a)(9), to treat the items allocated by LTP to UTP with respect to the machine as basis derivative items that are subject to Treas. Reg. § 1.704-3(a)(9). Indeed, failing to do so—or interpreting the regulation as not permitting this treatment—presents opportunities for abuse through the inappropriate shifting of gains and losses.

It should be noted that, to avoid the textual difficulty in the regulations in situations like those described in Example 10, some partnerships revalue LTP's assets, giving rise to a reverse section 704 layer at LTP, before contributing the LTP interest to UTP. As the section 704(c) rules generally apply to reverse section 704(c) allocations in the same manner in which they apply to forward section 704(c) allocations,[79] practitioners then take the position that Treas. Reg. § 1.704-3(a)(9) applies by its terms (with assistance from Treas. Reg. § 1.704-3(a)(6)). Although this approach is entirely consistent with the

[78] The legislative history to the Deficit Reduction Act of 1984 states that book-tax disparities are to be eliminated only by allocations of gain, loss, and "depreciation, depletion and *similar items*." (emphasis added). H.R. Rep. No. 861, 98th Cong. 2d. Sess. 856 (1984).

[79] Treas. Reg. § 1.704-3(a)(6).

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principles of the regulations, it is sometimes difficult to come within the somewhat limiting rules regarding revaluations in Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

To address this uncertainty (and relieve partnerships of the need to revalue assets to come within Treas. Reg. § 1.704-3(a)(9)), we recommend Treasury and the IRS confirm that Treas. Reg. § 1.704-3(a)(9) is not by its terms exclusive and does not preclude the application of its principles to other tiered partnership scenarios. Moreover, we recommend that the regulation make clear that the failure to apply those principles may be unreasonable.

e. Securities Partnerships/Aggregation

Treas. Reg. § 1.704-3(e) provides that, for purposes of making reverse section 704(c) allocations, a securities partnership may aggregate gains and losses from qualified financial assets ("**QFAs**") using any reasonable approach that is consistent with the purpose of section 704(c). As the preamble to the final regulations in 1994 indicates, securities partnerships were afforded this flexibility because the frequency with which they revalue their assets and the number of assets they own would make it unduly burdensome for those partnerships to make reverse section 704(c) allocations on an asset-by-asset basis. Treas. Reg. § 1.704-3(e) defines the terms "securities partnerships" and "QFAs" and sets forth two methods that generally are presumed to be reasonable aggregation methods.

In 2007, in response to changes in the marketplace, the IRS issued Revenue Procedure 2007-59, which provided more flexible rules for aggregating reverse section 704(c) allocations, but only for "qualifying partnerships" that met certain requirements. As we noted in 2010 in Report No. 1220 (the "**Securities Aggregation Report**"),[80] however, we believe that Revenue Procedure 2007-59, though welcome and helpful, because of its limited scope, left many partnerships unable to apply the aggregation rules even though permitting them to do so would be perfectly appropriate. We believe that, since the publication of the Securities Aggregation Report, market complexity has continued to increase, compounding the issues that the IRS sought to address in 2007 and that we raised in 2010. Although we are not addressing in this Report the specific issues raised in the Securities Aggregation Report, we refer readers to the Securities Aggregation Report.

f. Contingent income items

In Report No. 1274 (the "**Contingent Liabilities Report**"),[81] we addressed the question of whether and under what circumstances a partnership should be required to allocate basis adjustments under section 743(b) to contingent liabilities. As discussed in the Contingent Liabilities Report, contingent liabilities are properly treated as property for

[80] NYSBA Tax Section, "Report on Aggregation Issues Facing Securities Partnerships Under Subchapter K" (Sep. 29, 2010).

[81] NYSBA Tax Section, "Report on the Allocation of Basis Adjustments Under Section 743(b) to Contingent Liabilities" (Oct. 9, 2012).

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section 704(c) and section 755 purposes, and a partnership should be required to allocate basis adjustments to contingent liabilities to ensure that the deduction associated with the contingent liability is allocated only to contributing (or deemed contributing) partners.

In this Report, we will address this issue as applied to contingent income items (i.e., the other side of the issue addressed in the Contingent Labilities Report)—namely, whether, and in which circumstances, it is appropriate to treat contingent income items, such as deferred revenue, similarly to contingent liabilities for purposes of section 704(c) and section 755—and highlight that a partnership should allocate basis adjustments to that section 704(c) property to ensure that only the partners who have received the economic benefit of that property include the tax items in income when recognized by the partnership for tax purposes (i.e., that the income associated with the deferred revenue is allocated only to the contributing (or deemed contributing) partners).

a. Deferred Revenue as Partnership Property

Operating businesses frequently receive advance payments for goods or services to be provided at a later date. In limited circumstances, taxpayers are permitted to defer recognition of taxable income attributable to those prepayments. For example, section 451(c) provides a one-year deferral for certain advance payments for goods, services and use of the intellectual property,[82] section 455 provides a deferral method for prepaid subscription income related to periodicals, and section 456 provides a deferral for prepaid dues of certain membership organizations.

For purposes of this Report, deferred revenue means an amount that has been received by the partnership in one accounting period but that is more properly reportable in a different accounting period.[83] The deferred revenue itself is not a separate economic asset on a partnership's balance sheet, as the partnership's asset is cash at the time of its receipt. Rather, the deferred revenue is accounted for as taxable income in a later year.

Although deferred revenue is not itself a partnership asset in that it is not a tangible asset (like real estate) and is not an intangible asset (like stock in a corporation), consistent with other provisions applicable to partnerships, deferred revenue is an income item that should be viewed as property of the partnership for tax purposes. For example, section 751(a) characterizes gains from the sale of a partnership interest as ordinary income to the

[82] Revenue Procedure 2004-34, which was obsoleted by T.D. 9941 as of January 1, 2021, permitted accrual method taxpayers to elect to defer income inclusion for certain advance payments until the end of the taxable year following the taxable year of receipt if the income was also deferred for financial statement purposes. The Tax Cuts and Jobs Act of 2017 effectively codified the Revenue Procedure 2004-34 deferral method for advance payments with some changes.

[83] Under section 451(b)(1)(C), an accrual method taxpayer must recognize income upon the earlier of when the all events test is met or when the taxpayer includes the amount in revenue in its applicable financial statement. The "all events test" is met when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. § 1.451-1(a), § 1.446-1(c)(1)(ii).

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extent the gain is attributable to a partner's share of the partnership's unrealized receivables. Included in the definition of unrealized receivables in section 751(c) is a long list of items that are not property in the traditional sense but that instead are income (or potential income) associated with property. Examples include depreciation recapture and market discount on certain debt instruments.[84] Treas. Reg. § 1.755-1(a)(1), in allocating section 743(b) adjustments, treats unrealized receivables as separate assets of a partnership that are ordinary income property.[85] For purposes of section 704(c) and section 755, deferred revenue should be viewed as analogous to § 1.752-7 liabilities (within the meaning of Treas. Reg. § 1.752-7(b)(2)). § 1.752-7 liabilities are treated as section 704(c) property (i.e., built-in loss property),[86] which ensures that the deduction associated with the liability is borne by the contributing partner. Similarly, treatment of deferred revenue as section 704(c) property (i.e., built-in gain property) would ensure that the income associated with the deferred revenue is borne by the contributing partner.

Generally, treating items of contingent income as section 704(c) property would best serve the policies of section 704(c) and section 743(b) adjustments. Moreover, treating contingent income items in this manner would harmonize the treatment of such contingent income items with respect to a buyer of an interest in a partnership with contingent income items as compared to a buyer making a direct purchase of the partnership's assets. Moreover, this tax treatment would be consistent with the treatment of unrealized income items under section 751(a) and section 755.

> **Example 11**. X and Y each contribute $50 to LLC. LLC earns $100 of deferred revenue. Before the deferred revenue is included in income, Z contributes $100 to LLC in exchange for a 1/3 interest in LLC. In connection with Z's contribution, LLC does a revaluation. If the deferred revenue must be treated as reverse section 704(c) property with respect to X and Y, the $100 of income in respect of the deferred revenue will be allocated only to X and Y when recognized by LLC.

b. Sale of Partnership Interest

A purchaser of an interest in a partnership that has deferred revenue will step into the former partner's share of the deferred revenue, as the purchaser will be allocated the former partner's share of income when the deferred revenue is included by the partnership. This result follows from Treas. Reg. § 1.704-1(b)(2)(iv)(l), which requires that, upon a transfer of all or a part of an interest in the partnership, the capital account of the transferor

[84] The Code references property with respect to each of these items listed under section 751(c). The Treasury regulations under section 751 focus on the income and, in the case of section 1245 recapture, specifically notionally bifurcate the asset and treat the income as a separate zero basis asset. Treas. Reg. § 1.751-1.

[85] Although deferred revenue differs from an unrealized receivable, as the partnership holds cash with an obligation to perform as opposed to a right to payment, this distinction should not create a difference with respect to the tax treatment of deferred revenue, especially if the cash received is subject to forfeiture.

[86] Treas. Reg. § 1.752-7(c); Treas. Reg. § 1.704-3(a)(12).

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that is attributable to the transferred interest carries over to the transferee partner. If, as we believe is the case, the deferred revenue is property for section 704(c) purposes, then, as noted in Example 11, when it is revalued, the partners will have reverse section 704(c) amounts with respect to it. As Treas. Reg. § 1.704-3(a)(6) provides that the rules of Treas. Reg. § 1.704-3(a) apply to reverse section 704(c) amounts, it follows that, under Treas. Reg. § 1.704-3(a)(7), a transferee of an interest will succeed to the latent income associated with the deferred revenue. Under section 743(a), if a person acquires a partnership interest from an existing partner, the basis of the partnership's assets in the hands of the purchaser is not adjusted unless the partnership has an election under section 754 in effect for the year that includes the date of the transfer or the partnership has a "substantial built-in loss" immediately after the transfer. In such a case, a partnership increases its adjusted basis in its assets by the difference between the purchaser's basis in its partnership interest and the purchaser's proportionate share of the partnership assets (or decreases its adjusted basis in its assets if the difference is negative).

For purposes of determining the amount of the basis adjustment, the purchaser's proportionate share of the partnership's assets is calculated as the sum of the purchaser's interest in the partnership's previously taxed capital plus the purchaser's share of partnership liabilities.[87] To determine the purchaser's share in the partnership's previously taxed capital, a hypothetical transaction construct is used whereby the partnership sells all of its assets for cash in a fully taxable transaction equal to the fair market value of its assets immediately after the sale of the partnership interest.[88] The purchaser's share in the partnership's previously taxed capital is equal to the amount of cash the purchaser would receive on a liquidation of the partnership after the hypothetical transaction, plus any tax loss that would be allocated to the purchaser in the hypothetical transaction, minus any tax gain that would be allocated to the purchaser in the hypothetical transaction (in each case, including remedial allocations under Treas. Reg. § 1.704-3(d)).[89]

The following example illustrates the unintended and inappropriate consequences that would occur upon a sale of partnership interest if the deferred revenue is not treated as section 704(c) built-in gain property:

> **Example 12**. X and Y form LLC as equal members. Neither contributes any capital. LLC is an accrual method taxpayer. In Year 1, LLC enters into a contract pursuant to which it will receive a $300 payment in exchange for goods that will cost $270 to produce. In Year 2, LLC receives the $300 payment, which will be included in LLC's income in Year 3 and gives rise to a partnership liability equal to $300. Because the future inclusion of $300 is a liability of the partnership, immediately after LLC's receipt of the advance payment, each

[87] Treas. Reg. § 1.743-1(d)(1).

[88] Treas. Reg. § 1.743-1(d)(2).

[89] Treas. Reg. § 1.743-1(d)(1)(i) – (iii).

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member's basis in its LLC interest increases by its 50 percent share of the liability, from $0 to $150.

In Year 2, before LLC incurs any production costs and while it has an election under section 754 in effect, Y sells its LLC interest to Z for $15. Y's amount realized is $165 ($15 cash received plus relief of $150 liability under section 752(d)). Y realizes and recognizes $15 of gain ($165 amount realized less $150 outside basis). The entire gain realized and recognized is ordinary under section 751(a), as it is money received in exchange for Y's interest attributable to an unrealized receivable of LLC, taking into account Y's share of LLC's estimated production costs.

Z's basis in LLC is $165 ($15 purchase price plus $150 share of LLC's liability). Because LLC has a section 754 election in effect for the year that includes the date of the sale, it must adjust the basis of its assets with respect to Z under section 743(b). If the income side of the deferred revenue is not treated as a 704(c) property but the obligation to perform is treated as such, Z has a section 743(b) adjustment of ($135)[90] that should be allocated to the obligation to perform pursuant to section 755.[91]

In Year 3, LLC recognizes $300 of income from the deferred revenue, allocating $150 of income to each of X and Z. Over time, LLC incurs $270 of production costs, which it allocates equally to X and Z. Although Z recovers its ($135) section 743(b) adjustment, on a cumulative basis, each of X and Z reports $15 of ordinary income.

This example illustrates how both the purchaser and the seller of the partnership interest would recognize the same ordinary income twice. The deferred revenue is ordinary income to Y pursuant to section 751(a) and is ordinary income to Z when recognized by the partnership.

Although section 743(b) and the regulations under section 755 do not explicitly contemplate deferred revenue, both the contingent income item that is the deferred revenue and the partnership's obligation to perform should properly be seen as items of partnership property. For purposes of section 751(a), the deferred revenue is an unrealized receivable subject to the same hypothetical sale construct as with section 743(b), and the partnership's obligation to perform should be treated as section 704(c) property. Moreover, treating both the contingent income and the obligation to perform as tax items would lead to parallel

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[90] Z's negative section 743(b) adjustment amount of ($135) results from the difference between Z's share of LLC's built-in gain in goodwill of $15 and of LLC's built-in loss in the obligation to perform of ($150).

[91] If the income side of the deferred revenue is not property for purposes of section 755, but is (or will be) income allocated to Z, then any positive section 743(b) adjustment from the income side of the deferred revenue does not have property to attach to (as the income side of the deferred revenue is neither a capital asset nor a section 1231 asset).

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treatment for the purchaser and the seller. Otherwise, as illustrated above, unintended consequences would occur upon a taxable purchase of a partnership interest.

Instead, it would be consistent with the purpose of section 743(b) to treat the contingent income from the deferred revenue as section 704(c) built-in gain property and the obligation to perform as section 704(c)(1)(A) built-in loss property. The purpose of section 743(b) is to place the purchaser of an interest in a partnership in the same position as if the purchaser had bought a direct interest in the partnership's assets.[92] Such treatment would also mean that the income from the deferred revenue and the deduction from the partnership's obligation to perform are not taken into account twice.

> **Example 13**. The facts are the same as Example 12, except that the income side of the deferred revenue is also treated as a 704(c) property. Y still recognizes \$15 of ordinary income under section 751(a) on the sale of its interest to Z. Z has a section 743(b) adjustment of \$150 in the partnership's unrealized receivable and (\$135) in its share of the partnership's obligation to perform, for a net \$15 section 743(b) adjustment. In Year 3, LLC recognizes \$300 of income from the deferred revenue, allocating \$150 to each of X and Z. Z recovers its section 743(b) adjustment and is allocated \$0 of net income. Over time, as LLC incurs production costs, Z is allocated \$135 of these costs and recovers its (\$135) section 743(b) adjustment, for \$0 net deduction.

The preceding example shows that treating both the contingent income from the deferred revenue and the partner's share of the partnership's obligation to perform as partnership property subject to section 704(c) and section 743(b) adjustments best serves the policy goals of section 704(c) and section 743(b).

c. *Contributions to Partnerships and Revaluations*

As described earlier, treating deferred revenue as property subject to section 704(c) is consistent with the intent and policy of section 704(c). Treas. Reg. § 1.451-8(c)(4), however, generally requires the acceleration of the recognition of income from deferred revenue subject to section 451 upon the contribution of an obligation to perform (such as a contract giving rise to deferred revenue) to a partnership in a section 721 transaction. Nevertheless, we believe that principles similar to those described earlier should apply to contributions to partnerships, to the extent the contributing partner's recognition of the deferred revenue is not required to be accelerated pursuant to Treas. Reg. § 1.451-8(c)(4) or a similar rule. If a partner earned deferred revenue and then contributed the cash to a partnership in exchange for a partnership interest, as well as the associated requirement to, for example, deliver the associated goods or services, the contributing partner's capital account would equal the amount of cash contributed, reduced by the present value of the obligation to perform. However, if the contingent income associated with the deferred revenue is not treated as section 704(c) property with respect to the contributing partner, that income would not be allocated only to the contributing partner. Similarly, if a person

[92] S. Rep. No. 1622, at 96 (1954).

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contributes cash to a partnership that has earned deferred revenue, and the partnership revalues its assets in connection with the contribution, the non-contributing partners' capital accounts should reflect the current values of the deferred revenue and the associated obligation to perform. In such a situation, if the deferred revenue is treated as section 704(c) property, the non-contributing partners should have reverse 704(c) amounts associated with the pre-contribution deferred revenue and obligation to perform. As with contributions of deferred revenue to a partnership, treating deferred revenue and the obligation to perform as section 704(c) property ensures that only the partners who received the economic benefit of the deferred revenue are allocated the income from the deferred revenue.

We further recommend a general approach of treating amounts similar to deferred revenue, such as amounts under section 481, as section 704(c) property and as property for section 755 purposes. To the extent that any such amounts would otherwise cause a buyer to recognize gain or loss that was accrued pre-acquisition, then such amounts should be treated as section 704(c) property to the existing partners and as property for section 755 purposes to which basis adjustments under section 743(b) can attach.

g. Curative allocations

Treas. Reg. § 1.704-3(c) permits a partnership that uses the traditional method to correct distortions created by the ceiling rule by making reasonable "curative" allocations of tax items to reduce, or eliminate, book-tax disparities of its non-contributing partners.[93] Specifically, curative allocations permit a partnership to make allocations of items of income, gain, loss, or deduction, solely for tax purposes, that differ from the allocations of the corresponding book items, to reduce or eliminate any difference (or disparity) between the allocation of book and tax items that are made to the non-contributing partners. Curative allocations must also be reasonable, which requires that an allocation (1) not exceed the amount necessary to offset the ceiling rule limitation in the taxable year in which the curative allocation is made[94] and (2) must be expected to be made from tax items that will have substantially the same effect on the partners' tax liability as the item limited by the ceiling rule.[95] Therefore, if the ceiling rule limits the amount of tax items that can be allocated to a non-contributing partner, a partnership is permitted to allocate additional tax items to that partner (or away from that partner) under the traditional method with curative allocations.

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[93] The use of the traditional method with curative allocations permitted by Treas. Reg. § 1.704-3(c) is referred to by most lawyers and tax accountants as the "curative allocation method." Importantly, as is clear from a cursory reading of the regulations, there is no single curative method; rather, curative allocations may be made in many different ways (e.g., allocating extra depreciation to a non-contributing partner or allocating gross income away from a non-contributing partner).

[94] Treas. Reg. § 1.704-3(c)(3)(i).

[95] Treas. Reg. § 1.704-3(c)(3)(iii)(A).

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Example 14. X and Y are equal members of LLC. X contributes Asset 1, which has a tax basis of $40 and a fair market value of $100, has five years remaining on its cost recovery schedule, and is depreciable using the straight-line method.[96] Y contributes $100 of cash, which LLC uses to buy Asset 2, which also has a cost recovery schedule of five years and is depreciable using the straight-line method. LLC agrees to make curative allocations to cure the book-tax disparity arising each year attributable to Asset 1.

During Year 1, LLC claims $20 of section 704(b) book depreciation and $8 of tax depreciation with respect to Asset 1, and $20 of both section 704(b) book depreciation and tax depreciation with respect to Asset 2. LLC allocates the section 704(b) book depreciation attributable to each of Asset 1 and Asset 2 equally to X and Y. For tax purposes, however, LLC allocates all $8 of the tax depreciation from Asset 1 to Y.

Notwithstanding that special tax allocation, there is still a book-tax disparity of $2 (the difference between the $10 of book depreciation and $8 of tax depreciation) with respect to Y. Because X and Y have agreed to use curative allocations to cure distortions resulting from the application of the ceiling rule, LLC allocates to Y an additional $2 of tax depreciation from Asset 2 that otherwise would have been allocated to X. Therefore, X is allocated $8 of tax depreciation with respect to Asset 2, and Y is allocated $12 of tax depreciation with respect to Asset 2.

	X		*Y*	
	Book	Tax	Book	Tax
Contribution	$100	$40	$100	$100
Asset 1 Depreciation	(10)	0	(10)	(8)
Asset 2 Depreciation	(10)	(8)	(10)	(12)
Ending Capital Accounts	**$80**	**$32**	**$80**	**$80**

[96] Two somewhat unreliable shortcuts to determine whether a ceiling limitation will arise with respect to contributed property are as follows: The first is to divide the tax basis of the contributed property by its fair market value. If the resulting fraction is less than the percentage ownership of the non-contributing partners, there will be a ceiling limitation. Thus, in Example 14, there is expected to be a ceiling limitation because that fraction (40/100, or 40%) is less than Y's 50% ownership in LLC. The second is to multiply the fair market value of the contributed property by the percentage interest of the non-contributing partners. If the resulting amount is greater than the tax basis of the contributed property, there will be a ceiling limitation. Thus, in Example 14, because the fair market value of Asset 1 multiplied by Y's ownership percentage (100*50%, or 50) is greater than the tax basis of Asset 1 (40), there is expected to be a ceiling limitation.

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a. Incomplete Curative Allocations

The regulations explicitly provide that curative allocations cannot exceed the amount necessary to offset the effect of the ceiling rule limitation for the partnership's current taxable year,[97] but do not as clearly state the converse, i.e., that a curative allocation can be less than the amount necessary to fully offset the book-tax disparity created by the ceiling rule in the partnership's taxable year. Nevertheless, a partnership's right to make an "incomplete cure" is supported by the text of the regulations in at least three places. First, the regulations specifically state that curative allocations may be used to "reduce ***or*** eliminate disparities between book and tax items of non-contributing partners."[98] Second, the last sentence of Treas. Reg. § 1.704-3(c)(1) states that "[a] partnership may limit its curative allocations to allocations of one or more particular tax items (e.g., only depreciation from a specific property or properties) ***even if the allocation of those available items does not offset fully the effect of the ceiling rule***."[99] Finally, as noted above, Treas. Reg. § 1.704-3(c)(3)(i), which is part of rules regarding the determination of whether a curative allocation is reasonable, expressly states that a "curative allocation is not reasonable to the extent it exceeds the amount necessary to offset the effect of the ceiling rule for the current taxable year or, in the case of a curative allocation upon disposition of the property, for prior taxable years." Significantly, the regulation thus imposes a cap, but not a floor, or minimum, on the amount of a curative allocation.[100]

The operation of an incomplete cure is illustrated by the following example.

> **Example 15**. X and Y are equal members of LLC. X and Y are not related parties, bargain with each other at arm's length, and generally have adverse tax interests. X contributes Asset 1, which has a tax basis of $40 and fair market value of $100, has five years remaining on its cost recovery schedule and is depreciable using the straight-line method. Y contributes $100 of cash, which LLC uses to purchase inventory for resale. LLC agrees to make curative allocations to cure up to 50 percent of the book-tax disparity arising each year attributable to Asset 1.

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[97] Treas. Reg. § 1.704-3(c)(3)(i).

[98] Treas. Reg. § 1.704-3(c)(1) (emphasis added.)

[99] *Id*.

[100] Additionally, the preamble to the 1992 Proposed Regulations stated that a "curative allocation is reasonable only ***up to*** the amount necessary to offset the ceiling rule…" (emphasis added). 57 Fed. Reg. 61,350 (Dec. 24, 1992). This similarly implies that the drafters intended to impose a cap but not a floor.

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During Year 1, LLC sells all of its inventory for $110, recognizing $10 of section 704(b) income and taxable income, and claims $20 of section 704(b) book depreciation and $8 of tax depreciation with respect to Asset 1.

For section 704(b) book and tax purposes, LLC allocates $5 of income to each of X and Y. LLC also allocates $10 of 704(b) book depreciation attributable to Asset 1 to each of X and Y. For tax purposes, however, LLC allocates all $8 of the tax depreciation to Y. Notwithstanding the special tax allocation, there is a book-tax disparity of $2 with respect to Y (the difference between the $10 of book depreciation and $8 of tax depreciation allocated to Y).

Because LLC has agreed to cure 50 percent of the disparity created by the ceiling rule, LLC allocates an extra $1 of income to X solely for tax purposes.

	X		*Y*	
	Book	Tax	Book	Tax
Contribution	$100	$40	$100	$100
Asset 1 Depreciation	(10)	0	(10)	(8)
Sales Income	5	6	5	4
Ending Capital Accounts	**$95**	**$46**	**$95**	**$96**

Example 15 illustrates how an incomplete curative allocation works in practice. Although the curative allocation does not fully offset the effect of the ceiling rule, it is reasonable as it does not exceed the amount necessary to offset the effect of the ceiling rule and is made using tax items that are expected to have substantially the same effect on each partner's tax liability as the tax item affected by the ceiling rule.[101]

We emphasize, however, that not all incomplete curative allocations are permitted by the regulations, as incomplete curative allocations still must comply with the general requirement of Treas. Reg. § 1.704-3(c)(1) that permits only "***reasonable*** curative allocations to reduce or eliminate disparities between book and tax items of non-contributing partners."[102] Example 15 illustrates an incomplete curative allocation methodology that is reasonable, not only because the curative allocation does not exceed the amount necessary to offset the effect of the ceiling rule, but also because (in addition

[101] X and Y anticipate that the inventory income will have substantially the same effect on their tax liabilities as depreciation from Asset 1.

[102] Treas. Reg. § 1.704-3(c)(1). (emphasis added).

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to the other stipulated facts) X and Y agree to the incomplete curative allocation methodology at the outset of their agreement, and the methodology is not amended. We believe that this is an important factor in determining whether an incomplete curative allocation methodology is reasonable. We do not believe that an incomplete curative allocation methodology is reasonable if the portion of the book-tax disparity cured each year is amended retroactively or on a post-hoc basis.[103] Such a methodology would present vast opportunities for abuse by allowing taxpayers to shift tax consequences among themselves and between favorable taxable years, which may run afoul of the requirement to apply a section 704(c) method consistently.

Nevertheless, reasonable incomplete curative allocations are permitted (and, indeed, contemplated) by the regulations, as noted above. Additionally, from a policy perspective, allowing for incomplete curative allocations is not inconsistent with the policy goals of section 704(c)—that is, requiring allocations to take into account differences between the fair market value of property at the time of contribution or revaluation and the property's adjusted basis while permitting some flexibility as to the way in which this is done. Given that the traditional method, which can lead to the application of the ceiling rule, is permitted, it is understandable why the regulations permit incomplete cures. Nevertheless, it would be helpful if Treas. Reg. § 1.704-3(c) were revised to make more explicit that reasonable incomplete cures are permissible and if an example were added to Treas. Reg. § 1.704-3(c)(4) showing reasonable incomplete curative allocations.

b. Make-Up Curative Allocations

The Treasury regulations provide that a curative allocation generally is unreasonable if the amount allocated exceeds the amount necessary to offset the effect of the ceiling rule limitation in the taxable year. Notwithstanding this general rule, the regulations contain an exception,[104] which is found in the portion of the regulations addressing the reasonableness requirement. Specifically, the exception states that the

[103] We note, however, that an incomplete curative allocation methodology may be reasonable even if the portion of the book-tax disparity cured each year varies, provided that such a variation is part of the previously agreed-upon methodology.

[104] The regulations actually create two exceptions. The first is discussed in the text. The second, which commonly is referred to as the "gain-on-sale" rule, provides that if cost recovery has been limited by the ceiling rule, the general limitation on character does not apply to income from the disposition of contributed property subject to the ceiling rule, but only if properly provided for in the partnership agreement in effect for the year of contribution or revaluation. Treas. Reg. § 1.704-3(c)(3)(iii)(B). As a practical matter, this means, for example, that if allocations of tax depreciation deductions to a non-contributing partner have been limited by the ceiling rule, a curative allocation to the contributing partner of gain from the sale of that property is reasonable if properly provided for in the partnership agreement. We note that this exception is located under the "type" rule, presumably under the assumption that the gain from the sale of the property would be capital gain, whereas the depreciation deductions that were limited would be ordinary. It is possible, of course, that all or a portion of the gain may be ordinary (e.g., by reason of application of section 1245 or section 1239), and the rule is not limited by its terms to instances in which there are character mismatches between the cost recovery deductions previously allocated and the gain recognized on the sale of the property.

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period of time over which curative allocations are made is a factor in assessing the reasonableness of the cure and provides that a partnership is permitted to make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year only to the extent the curative allocations are (1) made over a reasonable period of time (such as the property's remaining economic useful life) and (2) provided for under the partnership agreement in effect for the year of the contribution of the section 704(c) property.[105]

Although the exception is in certain respects generous and taxpayer friendly, its requirement that any such curative allocations be made over the contributed property's remaining economic life can create book-tax disparities and prevent partnerships from immediately offsetting the full effect of the ceiling rule if, as typically is the case, the contributed property's remaining economic life exceeds its tax cost recovery schedule. *Example 3* under Treas. Reg. § 1.704-3(c)(4) examines this exact situation and concludes that, because the contributed property had an economic life of 10 years but one year remaining on its cost recovery schedule, curative allocations over the property's tax cost recovery schedule would not be reasonable.[106] The example evidences the fact that the exception is not necessarily taxpayer friendly; it perhaps is better understood as a regulatory means of ensuring that curative allocations are not used to permit taxpayers to use partnerships to traffic in accelerated depreciation.

The general rule and the exception have an interesting history. In 1992, Treasury and the IRS proposed regulations that implemented the changes made to section 704(c) (now section 704(c)(1)(A), as discussed above) in 1984 and also introduced the traditional method with curative allocations (the "**1992 Proposed Regulations**"). The preamble to the 1992 Proposed Regulations specified that "[i]f a partnership does not have tax items sufficient to make a reasonable curative allocation, the partnership may make the curative allocation in the next taxable year that it has sufficient other items of the correct type, provided that the curative allocation, when made, is reasonable."[107] Consistent with the text of the preamble, Prop. Treas. Reg. § 1.704-3(c)(1) provided that "[i]f a partnership does not have other tax items of income, gain, loss, or deduction sufficient in the amount and of the correct type to equalize allocations of book and tax items, the partnership may choose to make the curative allocation in the next succeeding taxable year in which it has

[105] Treas. Reg. § 1.704-3(c)(3)(ii).

[106] *See* Treas. Reg. § 1.704-3(c)(4), Ex. 3(ii)(C). It should be noted that Example 3 also implicates the anti-abuse rule of Treas. Reg. § 1.704-3(a)(10) as the contributing partner, at the time of contribution, had "substantial net operating loss carryforwards that [the contributing partner anticipated would] otherwise go unused," and contributed the section 704(c) property "with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although it has an estimated remaining economic life of 10 years." The traditional method with curative allocations (as with all methods for making section 704(c) allocations) must pass muster under the anti-abuse rule, which seems extremely relevant to the facts at hand in Example 3. If Treasury and the IRS do not follow the recommendation made in this section, we suggest supplementing Treas. Reg. § 1.704-3(c)(4) with an example that does not implicate the anti-abuse rule.

[107] Preamble to proposed regulations, 57 Fed. Reg. 61,346 (Dec. 24, 1992).

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sufficient other items of the correct type,"[108] thereby permitting partnerships to cure the effects of the ceiling rule limitations through what are referred to by many practitioners as "make-up curative allocations."

In 1993, the IRS and Treasury issued final regulations on section 704(c) (the "**1993 Regulations**"), which did not contain the make-up allocation rule. The preamble to the 1993 Regulations noted that the "IRS and Treasury believe that those taxpayers that are concerned about this restriction [(i.e., the potential for insufficient items to cure in a given year and the inability to make make-up curative allocations)] can choose to use the remedial allocation method described in the temporary regulations."[109] For this reason, the 1993 Regulations introduced the limitations discussed above on a partnership's ability to make curative allocations in a taxable year to offset the effect of the ceiling rule for a prior taxable year.

We disagree with the IRS and Treasury's decision in the 1993 Regulations for a number of reasons and suggest that it be reconsidered. Firstly, as noted above in footnote 104, in the "gain on sale" context, the existing regulations permit partnerships to make make-up allocations without regard to the timing of the sale relative to the application of the ceiling limit that is being cured. It is difficult to discern a reason for allowing make-up allocations in that context but prohibiting them in other contexts.

Secondly, we believe that allowing make-up curative allocations is consistent with the policy goals of section 704(c) for the same reasons that the remedial allocation method is consistent with those policy goals. That is, the remedial allocation method addresses the timing issue by artificially extending the depreciation schedule of contributed (or revalued) property. We see no reason why that mechanic, while innovative and effective, should be the only means of addressing the underlying issue—the concern regarding the unavailability of sufficient items to cure a ceiling rule limitation in a given year, so long as make-up allocations are subject to the general reasonableness requirement of Treas. Reg. § 1.704-3(a)(1).[110,111]

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108 57 Fed. Reg. 61,350 (Dec. 24, 1992).

109 TD 8500.

110 We note that although make-up allocations may result in some accelerated depreciation for a non-contributing partner, this is the case with all contributions of depreciable or amortizable property and is adequately addressed by the existing regulations. Moreover, provided that the contributing and non-contributing partners are in the same or similar tax brackets and are otherwise similarly situated, there is no substantial reduction in the present value of the partners' aggregate tax liability, making it difficult to discern any tax policy concerns with permitting those allocations.

111 We would note that in NYSBA Tax Section Report 790, we briefly touched on make-up curative allocations, indicating our belief that curative allocations made over the remaining depreciable life of contributed property (rather than remaining economic useful life) are not per se unreasonable but simply lack the imprimatur of reasonableness otherwise conferred on curative allocations. NYSBA Tax Section, Report No. 790: "Report on Treasury Regulation § 1.704-3T and Certain Other Section 704(c) Matters" (April 25,
(….continued)

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For those reasons, we recommend that Treas. Reg. § 1.704-3(c)(3)(ii) be amended to provide partnerships with the ability to make make-up curative allocations in accordance with the 1992 Proposed Regulations.

h. Remedial allocation method – effect of basis adjustments (e.g., section 734(b) adjustments)

Under the remedial allocation method, for purposes of determining the amount of section 704(b) book items (generally, depreciation or amortization) that a section 704(c) property generates, the property is notionally bifurcated into one notional asset with book basis and fair market value equal to the tax basis of the asset and a second notional asset with zero tax basis and fair market value equal to the built-in gain in the asset. The first notional asset is depreciated or amortized over its remaining recovery schedule. The second notional asset is treated as depreciated or amortized using any method available to the partnership for newly purchased property of the same type as the section 704(c) property. The partnership then combines the two amounts of section 704(b) book depreciation, allocates the book depreciation to the partners under the partnership agreement, and applies the normal rules of section 704(c) to the available tax depreciation (i.e., allocates the tax depreciation first to the non-contributing partners to equal the book depreciation allocated to them). If there is insufficient tax depreciation to allocate to the non-contributing partners, the partnership creates sufficient depreciation to allocate to the non-contributing partners and allocates an equal and offsetting amount of income to the contributing partner.

> **Example 16**. X and Y form LLC. X contributes a depreciable asset (Asset 1) with a tax basis of $30 and fair market value of $100. Y contributes $100 of cash. LLC adopts the remedial allocation method with respect to Asset 1. (Asset 1 has two years remaining on its depreciation schedule and would be depreciable over a 10-year period if it were newly purchased at the time it was contributed to LLC.)
>
> Under the remedial allocation method, Asset 1 is notionally divided into two assets, one with a tax basis and fair market value of $30 and a second asset with a zero tax basis and a fair market value of $70. The first notional asset gives rise to $15 of book and tax depreciation in each of Years 1 and 2 and is then fully depreciated. The second notional asset gives rise to $7 of book depreciation and no tax depreciation for Years 1-10 and is then fully depreciated. Therefore, in years 1 and 2, Asset 1 gives rise to a total $22 of

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1994). We suggested that the regulations be clarified to confirm that such make-up allocations stand on the same footing as other methods not explicitly described in the regulations; meaning, that so long as it is demonstrated that the allocation method is reasonable as applied to the particular case, then the use of such a method should be permissible. We reiterate our view that such allocations are not per se unreasonable and continue to believe that the reasonableness requirement provides appropriate guardrails against potential abuses and that further limitations therefore are unnecessary.

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book depreciation and $15 of tax depreciation; in Years 3-10, Asset 1 gives rise to $7 of book depreciation and $0 tax depreciation.

The impact of the allocation of depreciation for the first four years of LLC's operations is shown below:

	X		*Y*	
	Book	Tax	Book	Tax
Beginning Capital Account	100	30	100	100
Year 1 Depreciation	(11)	(4)	(11)	(11)
Year 1 Remedial Allocations	--	0	--	0
Year 2 Depreciation	(11)	(4)	(11)	(11)
Year 2 Remedial Allocations	--	0	--	0
Year 3 Depreciation	(3.5)	0	(3.5)	0
Year 3 Remedial Allocations	--	3.5	--	(3.5)
Year 4 Depreciation	(3.5)	0	(3.5)	0
Year 4 Remedial Allocations	--	3.5	--	(3.5)
Capital Accounts at End of Year 4	$71	$29	$71	$71

The remedial allocation method implicitly assumes that the basis of the relevant section 704(c) property is adjusted only by depreciation (or amortization) and is not otherwise adjusted during its depreciable life. If the partnership's basis in the section 704(c) property is adjusted, e.g., as a result of a section 734(b) adjustment, however, new book-tax disparities may be created, as is illustrated by the following example.[112]

Example 17. Continuing with the facts of Example 16 and assuming that the fair market value of LLC's assets equals their section 704(b) book basis, at the beginning of Year 5, LLC distributes $49 of cash to X in redemption of 69 percent ($49 / $71) of X's LLC interest. The distribution results in X's recognizing $20 of gain ($49 cash distribution minus $29 outside basis).[113]

[112] This phenomenon is explored in Monte A. Jackel and Shari R. Fessler, *The Mysterious Case of Partnership Inside Basis Adjustment*, 89 Tax Notes (TA) 529 (Oct. 23, 2000).

[113] For simplicity, the application of section 751(b) is disregarded.

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Because LLC has a section 754 election in effect for the taxable year that includes the date of the distribution, LLC increases the basis of its assets under section 734(b) by $20. Under section 755 and Treas. Reg. § 1.755-1(c), the adjustment is allocated to LLC's only asset, Asset 1,[114] increasing its basis from zero to $20. The impact of the distribution on the members' book and tax capital accounts would be as follows:

	X		***Y***	
	Book	Tax	Book	Tax
Year 5 Opening Capital Account	71	29	71	71
Distribution	(49)	(49)	0	0
Section 731(a) Gain	0	20	0	0
Capital Account After Distribution	22[115]	0[116]	71	71

After the distribution, X holds a 23 percent interest in LLC, and Y holds a 77 percent interest in LLC. The section 734(b) adjustment is depreciated over 10 years (giving rise to $2 of tax depreciation each year for 10 years) because the section 734(b) regulations require that the positive adjustment be recovered over the 10-year recovery life over which Asset 1 would be depreciated were it newly purchased.[117] Assuming no change is made to the book depreciation

[114] Under the regulations under section 755, there are situations in which this adjustment would not attach to Asset 1 if it has a zero basis. For simplicity, this is disregarded.

[115] Under Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4) and (5), no adjustment is made to the members' section 704(b) book capital accounts because the section 734(b) adjustment does not exceed the difference between $42, the section 704(b) book basis of Asset 1 and $0, its tax basis.

[116] There is some informal guidance on the impact of a section 734(b) adjustment on the partners' tax basis capital accounts. *See, e.g.*, 2024 Instructions to Form 1065 at page 36, which provides that a partner's tax basis capital account is increased by the partner's distributive share of any increase to the tax basis of partnership property under section 734(b). However, the informal guidance does not shed light on how the partner's distributive share is determined, and we are not aware of any formal guidance on the impact of a section 734(b) adjustment on the partners' tax basis capital accounts. Nevertheless, Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4) is instructive. Under that regulation, in the case of a basis adjustment that arises in connection with a partial redemption, the partners' capital accounts are adjusted to reflect the manner in which the unrealized gain that is displaced by the adjustment would have been shared if the property whose basis is adjusted were sold immediately before the adjustment for an amount equal to its basis as adjusted. In Example 17, if Asset 1 were sold for $20, LLC would have no book gain (indeed, it would have a book loss of $22) but would have $20 of tax gain, all of which would be allocated to X under section 704(c). The impact of section 734(b) adjustments on the partners' section 704(c) amounts is discussed in Part j, below.

[117] Treas. Reg. § 1.734-1(e)(1).

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schedule of Asset 1 to account for the section 734(b) adjustment, the impact of the allocation of depreciation for Years 5-10 is shown below:

	X		***Y***	
	Book	Tax	Book	Tax
Capital Account After Distribution	22	0	71	71
Year 5 Depreciation	(1.6)	0	(5.4)	(2)
Year 5 Remedial Allocations	--	3.4	--	(3.4)
Year 6 Depreciation	(1.6)	0	(5.4)	(2)
Year 6 Remedial Allocations	--	3.4	--	(3.4)
Year 7 Depreciation	(1.6)	0	(5.4)	(2)
Year 7 Remedial Allocations	--	3.4	--	(3.4)
Year 8 Depreciation	(1.6)	0	(5.4)	(2)
Year 8 Remedial Allocations	--	3.4	--	(3.4)
Year 9 Depreciation	(1.6)	0	(5.4)	(2)
Year 9 Remedial Allocations	--	3.4	--	(3.4)
Year 10 Depreciation	(1.6)	0	(5.4)	(2)
Year 10 Remedial Allocations	--	3.4	--	(3.4)
Capital Accounts at End of Year 10	$12.4	$20.4	$38.6	$38.6

As can be seen, at the end of Year 10, Y's book and tax capital accounts are balanced, meaning that section 704(c) has operated properly (because Y did not contribute section 704(c) property to LLC). X's book and tax capital accounts, however, are curiously imbalanced. X contributed Asset 1 with a built-in gain, yet X now has an $8 built-in loss in its LLC interest ($20.4 tax basis over $12.4 value).[118]

This $8 difference can be explained by the fact that LLC has an $8 remaining section 734(b) adjustment with respect to Asset 1 that will be depreciated over Years 11 through 14. Provided that all of the remaining depreciation, which will not produce any section 704(b) depreciation, is allocated entirely to X, X's book and tax capital accounts

[118] Although this discussion and this example focus on the remedial method, we would note that this phenomenon can occur under the traditional or curative allocation method as well.

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will ultimately equal, and its built-in loss will be eliminated. Although such a special allocation seems entirely sensible (and perhaps compelled by the q rule and basic principles underlying subchapter K), there is no authority that makes clear that the $8 of tax-only depreciation can or must be allocated entirely to X. Moreover, even if that special allocation of depreciation to X is proper, the presence of a built-in loss in X's interest leads to the potential for inappropriate results and (potentially) inappropriate tax planning.[119]

One way to address this would be to adjust the period of time over which the section 734(b) adjustment is recovered so that it matches the remaining section 704(b) book life of the asset. That is, in Example 17, the $20 section 734(b) adjustment could be recovered over Years 5-10, or $3.33 in each year, in which case the capital accounts of the members would be as follows:

	X		***Y***	
	Book	Tax	Book	Tax
Capital Account After Distribution	22	0	71	71
Year 5 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 5 Remedial Allocations	--	2.07	--	(2.07)
Year 6 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 6 Remedial Allocations	--	2.07	--	(2.07)
Year 7 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 7 Remedial Allocations	--	2.07	--	(2.07)
Year 8 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 8 Remedial Allocations	--	2.07	--	(2.07)
Year 9 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 9 Remedial Allocations	--	2.07	--	(2.07)
Year 10 Depreciation	(1.6)	0	(5.4)	(3.33)
Year 10 Remedial Allocations	--	2.07	--	(2.07)
Capital Accounts at End of Year 10	$12.4	$12.4	$38.6	$38.6

[119] Similar distortions can occur when, for example, a partner that contributes section 704(c) property is fully redeemed. The distortions can be compounded if there are revaluations of partnership property in connection with the redemption. For a discussion of this point, *see* Jackel *supra* note 113.

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The regulations under section 734(b) could be amended to reach this result. Treas. Reg. § 1.734-1(e) currently provides that "if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs." The regulation could be modified in a manner similar to the section 743(b) regulations, which provide that if a partnership uses the remedial allocation method with respect to an item of depreciable or amortizable property, the portion of any positive section 743(b) adjustment allocable to that property "that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of § 1.704-3(d)(2)."[120]

These examples make clear that, despite the prevailing conception that remedial allocations fully cure all book-tax disparities before they arise, there are situations in which they do not. We therefore recommend that Treasury and the IRS consider providing guidance consistent with our discussion above and further providing that, in situations in which guidance is lacking, partnerships may make reasonable adjustments to section 704(b) book amortization and section 704(c) allocations to prevent (or minimize) the creation of book-tax disparities.

i. Remedial allocation method – character of remedial income allocations

The 1992 Proposed Regulations included the deferred sale method, which, as discussed above, originated from the 1954 ALI report, and under which a contribution of section 704(c) property to a partnership generally would have been treated as a sale of the property to the partnership, with deferred recognition of the gain or loss on the sale.[121] As such, the partnership would have received a fair market value basis in the property, but the contributing partner's outside basis would have equaled its basis in the contributed property until the deferred gain or loss on the sale was recognized. The deferred gain or loss generally would have been recognized by the contributing partner (either partially or fully) as a result of basis recovery by the partnership (e.g., depreciation deductions), a disposition of the property by the partnership or a partial or full disposition by the contributing partner of its partnership interest.

[120] Treas. Reg. § 1.743-1(j)(4)(i)(B)(2). Alternatively, the section 704(b) depreciation schedule of the asset could be adjusted to match the longer tax depreciation, but such an approach would be inconsistent with the approach taken in the analogous portion of the section 743(b) regulations, as discussed in the text.

[121] We note that for purposes of the CAMT proposed regulations governing contributions of property to a partnership with financial accounting built-in gain or loss, the drafters adopted a variation of the deferred sale approach included in the 1992 Proposed Regulations. Proposed Treas. Reg. § 1.56A-20(c)(2)(i). This approach has since been modified by Treasury and the IRS in Notice 2025-28. Notice 2025-28, 2025-34 I.R.B. 316 (Aug. 18, 2025).

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The 1993 Final Regulations replaced the deferred sale method with the remedial allocation method. It generally is believed that the deferred sale method was dropped because it proved to be overly complex to craft appropriate rules regarding which sorts of transactions should trigger the deferred gain or loss.[122]

We do not believe that revisiting the deferred sale method wholesale is a worthwhile endeavor, yet we do think it is worthwhile to consider whether, solely for purposes of determining character and other attributes of remedial income allocations, the deferred sale method provides an appropriate framework.

That is, although the hallmark of the remedial allocation method is that there is matching of remedial income and remedial deductions (with respect to both timing and character) such that the allocations fully offset and therefore do not affect total partnership income or loss,[123] there is a question as to whether this is required by the Code.[124] Additionally, determining the character of inclusions triggered by depreciation or amortization (each of which can be conceived of as a partial disposition of the relevant property) by reference to the character of gain that would be recognized on a hypothetical sale transaction by the contributing partner is more consistent with other parts of section

[122] In TD 8500, the preamble regarding the withdrawal of the deferred sale method, Treasury provided the following explanation: "In the absence of specific published guidance, it is not reasonable to use a section 704(c) method in which the basis of property contributed to the partnership is increased (or decreased) to reflect built-in gain (or loss) and, except as provided in the temporary remedial allocation method regulations, it is also not reasonable for a partnership to create tax allocations of income, gain, loss, or deduction independent of allocations affecting the partnership book capital accounts." However, in TD 8501, the preamble to the temporary regulations that set forth the remedial method, it appears Treasury refined its thinking regarding the rationale for the removal of the deferred sale method and included the following explanation: "After considering the many comments received concerning the deferred sale method and upon further review by the IRS and Treasury, it was determined that the results of the deferred sale method in the original proposed regulations could be achieved using a less complex method."

[123] We note that, even under the existing section 704(c) regulations, there often is not perfect offsetting with respect to a remedial deduction and its offsetting remedial income. For example, the regulations provide that if the remedial deduction is depreciation, the offsetting remedial allocation to the contributing partner is income of the type produced (directly or indirectly) by the section 704(c) property. Treas. Reg. § 1.704-3(d)(3). A depreciation deduction may, for example, favorably impact (or not harm) section 163(j) calculations (because under current law, depreciation deductions may be added back in calculating "adjusted taxable income"), whereas the offsetting remedial income does not negate an addback of depreciation to adjusted taxable income for section 163(j) purposes. *See* section 163(j)(8)(A)(v).

[124] *See, e.g.*, TD 8585 ("The final regulations also clarify that, because remedial allocations to non-contributing partners and offsetting remedial allocations to the contributing partner net to zero at the partnership level, remedial allocations do not affect the partnership's computation of its taxable income under section 703.") Importantly, the preamble does not indicate that this result is required by section 704(c), nor did the preamble in TD 8500 indicate any legal or conceptual discomfort with the deferred sale method, which similarly does not necessarily result in the character of the deferred gain or loss recognized by the contributing partner matching the character of the associated income, gain, loss or deduction at the partnership level that triggers the deferred gain or loss recognition.

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704(c), including the consequences of a taxable disposition of section 704(c) property as well as the application of section 704(c)(1)(B).[125]

We therefore suggest that Treasury and the IRS consider whether character and other attributes with respect to remedial income allocations should be determined based on a hypothetical sale of the relevant section 704(c) property rather than based on the character and other attributes of the corresponding remedial deductions.[126]

j. Interaction of Sections 734 and 755

Under section 734(b), if a partnership has an election under section 754 (a "**section 754 election**") in effect or if there is a "substantial basis reduction," certain distributions can cause the partnership to adjust its basis in some or all of its assets (such adjustments "**section 734 adjustments**"). Section 734 adjustments can be positive or negative.[127] Regulations promulgated under section 755[128] provide that section 734 adjustments are allocated either to all capital gain property (and section 1231 property) that the partnership owns (in the case of an adjustment under section 734(b)(1)(A) or 734(b)(2)(A))[129] or to the partnership's property that is the same class (i.e., capital gain or ordinary income) as the property that gave rise to the adjustment (in the case of an adjustment under section 734(b)(1)(B) or 734(b)(2)(B)).[130] A positive section 734 adjustment is allocated first to increase the adjusted basis of the appreciated property within the appropriate class in

[125] In the case of a taxable disposition of section 704(c) property, the character of the income or gain is determined by reference to the character recognized by the partnership. Thus, for example, if section 1239 or section 707(b)(2) applies, capital gain could be converted into ordinary income; if loss property is sold to a related person, the loss could be disallowed under section 267(a)(1) or section 707(b)(1). Under Treas. Reg. § 1.707-4(b), the character of gain or loss recognized by the contributing partner similarly is determined as if the distributed property had been sold by the partnership to the distributee partner. "As a result, if built-in loss property is distributed to a partner that holds more than a 50 percent interest in partnership capital or profits, the built-in loss that otherwise would be recognized is disallowed under section 707(b)(1)(A)." T.D. 8642, Preamble to Final Section 704(c)(1)(B) regulations (Dec. 22, 1995) (describing the approach of the proposed regulations under section 704(c)(1)(B) and rejecting commentators' request that the approach be changed).

[126] We recognize that determining character with respect to remedial income allocations based on a hypothetical sale of the relevant section 704(c) property reaches a potentially favorable result as to "character" for the contributing partner while also permitting the taxpayer to defer capital gain that would have been recognized in such a hypothetical sale. As such, if Treasury and the IRS ultimately provide that the character of remedial income allocations should be determined based on a hypothetical sale of the applicable section 704(c) property, Treasury and the IRS should consider whether an interest charge should be imposed (under principles similar to the principles of section 453A).

[127] *See* section 734(b)(1) (positive adjustments) and (2) (negative adjustments).

[128] *See* section 734(c) that requires the basis be allocated among the partnership's assets in accordance with the rules in section 755.

[129] Treas. Reg. § 1.755-1(c)(1)(ii).

[130] Treas. Reg. § 1.755-1(c)(1)(i).

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proportion to (and to the extent of) unrealized appreciation, with any remaining positive adjustment allocated among the partnership's assets in the appropriate class in proportion to relative fair market values.[131] A negative section 734 adjustment is allocated first to decrease the adjusted basis of property within the appropriate class in proportion to unrealized depreciation, with any remaining negative adjustment allocated among the partnership's assets in the appropriate class in proportion to (and to the extent of) relative adjusted tax bases.[132]

Although the general framework for sections 734 and 755 is clear (albeit broken[133]), the interaction between sections 734/755 and 704(c) is less clear. Neither the statute nor the regulations make any attempt to harmonize or integrate basis adjustments under sections 734/755 and section 704(c) accounts.[134] As a result, section 734 adjustments can have odd effects on the section 704(c) amounts with respect to partnership property.

> **Example 18**. X contributes Asset 1, a capital asset with a basis of $40 and value of $100, Y contributes Asset 2, also a capital asset with a basis of $40 and value of $100, and Z contributes $100 to LLC. X, Y, and Z are equal members in LLC. Several years later, in an unrelated transaction, when bases and values remain unchanged, LLC distributes $90 to X in partial redemption of X's LLC interest. X recognizes $50 of gain under section 731(a) (the excess of $90 of cash over $40 outside basis). Because LLC has a section 754 election in effect for the year that includes the date of the distribution, LLC adjusts the basis of Asset 1 and Asset 2 by $25 each.[135]
>
> As a result of the section 734 adjustment, X's and Y's section 704(c) amounts are reduced by $25 each, even though X recognized all of the gain under section 731(a).

The result described in Example 18 is clearly mandated by the regulations but has the effect of creating a $25 inside-outside basis disparity with respect to each of X and

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[131] Treas. Reg. § 1.755-1(c)(2)(i).

[132] Treas. Reg. § 1.755-1(c)(2)(ii).

[133] *See, e.g.*, Howard E. Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 Tax L. Rev. 343 (2004).

[134] On the other hand, section 743(b) adjustments do take section 704(c) into account when calculating the purchasing partner's previously taxed capital. *See, e.g.*, Treas. Reg. § 1.743-1(d)(3), *Example 2*.

[135] Section 734(b)(1)(A) and Treas. Reg. § 1.755-1(c)(1)(ii).

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Y.[136] If the entire adjustment had reduced X's section 704(c) amounts, no basis disparities would have been created.[137]

A conceptually similar issue arises in situations in which multiple partners have section 704(c) gain with respect to a single asset and a section 734 adjustment (attributable to gain recognized by only one of those partners) attaches to that asset: There is no guidance regarding whose share of section 704(c) gain is reduced by the section 734(b) adjustment.

> **Example 19**. X and Y each contribute $50 to LLC, which uses the $100 to purchase Asset 1. Asset 1 immediately doubles in value to $200, and Z contributes $100 to LLC in exchange for a 1/3 interest in LLC. Immediately before Z's admission, LLC revalues its assets under Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i), increasing the book basis of Asset 1 from $100 to $200 and increasing each of X's and Y's capital accounts from $50 to $100.
>
> Several years later, in an unrelated transaction, when basis and value remain unchanged, LLC distributes $90 to X in partial redemption of its LLC interest. X recognizes $40 of gain under section 731(a) (the excess of $90 of cash over $50 outside basis). Because LLC has a section 754 election in effect for the year that includes the date of the distribution, LLC adjusts the basis of Asset 1 by $40.[138]
>
> If the $40 adjustment reduces the section 704(c) gain of both X and Y, the adjustment creates the same inside-outside basis disparities as described in the previous example. If, on the other hand, only X's share of the section 704(c) gain is reduced, then no disparities are created.

We are not aware of any guidance that specifically addresses these issues.[139] As noted, although the result in Example 18 creates inside-outside disparities for the partners, it is mandated by the section 755 regulations. The impact on the partners' section 704(c)

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[136] X's outside basis is $0 after the distribution, but its share of inside basis (calculated under Treas. Reg. § 1.743-1(d)) is negative $25. Y's outside basis remains $40 after the distribution, but its share of inside basis (also calculated under Treas. Reg. § 1.743-1(d)) has increased to $65.

[137] In that case, X's outside basis would still be $0 after the distribution, but its inside basis (calculated under Treas. Reg. § 1.743-1(d)) also would be $0. Similarly, Y's outside basis would remain $40 after the distribution, and its inside basis (also calculated under Treas. Reg. § 1.743-1(d)) also would be $40.

[138] Section 734(b)(1)(A) and Treas. Reg. § 1.755-1(c)(1)(ii).

[139] Treas. Reg. § 1.197-2(h)(12)(iv)(D)(1), which addresses the anti-churning rules of section 197(f)(9), and the rule of section 197(f)(9)(E) as applied to section 734(b) adjustments provide that each partner's share of a section 734(b) adjustment is determined by reference to the partners' relative capital accounts. The use of that measurement was a reasonable policy decision in that context because the implicit assumption in that regulation is that amortization from the adjustment will be shared in accordance with economic ownership of the partnership. We do not believe that rule informs the analysis of the issue discussed in the text.

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amounts in Example 19, however, is not dictated (or informed) by section 755. Instead, as demonstrated by Example 19, the resolution to the issue can affect the partners' shares of section 704(c) gain. For this reason, we believe that the manner in which the section 734(b) adjustment is treated as reducing the partners' section 704(c) amounts in Example 19 is properly viewed as a method under the section 704(c) regulations, meaning that partnerships have substantial flexibility in determining the manner in which the section 734(b) adjustment impacts the partners' shares of section 704(c) amounts in the adjusted property.

We recommend that, to address the fact pattern stated in Example 18, Treasury and the IRS revise the regulations under section 755 to ensure that, to the maximum extent possible (taking into account section 751(b)), section 734(b) adjustments are allocated among partnership assets in a manner that avoids creating or increasing inside-outside basis disparities. Similarly, even if the regulations were not amended, we recommend that guidance be issued confirming that the manner in which a section 734(b) adjustment reduces different partners' shares of section 704(c) amounts in a particular asset is a section 704(c) method with the result that flexibility be afforded to partners in making these determinations, subject to the application of the general reasonableness requirement of the section 704(c) regulations.[140]

k. Swapping of reverse section 704(c) amounts in the context of section 751(b)[141]

We have twice examined whether partners should be permitted to "swap" reverse section 704(c) amounts resulting from a distribution of hot assets to a partner, thereby narrowing the application of section 751(b). As we noted in Report No. 1122 (the "**First 751(b) Report**"), which predated the promulgation of proposed regulations primarily concerning partnership distributions subject to section 751(b) (the "**Proposed 751(b) Regulations**"), "[t]here is little guidance about how to apply reserve section 704(c) principles in general and no guidance as to how to apply these principles in the context of Section 751(b)." In the First 751(b) Report, we indicated that an approach that permits swapping "would require detailed guidance […] and would create additional complexity in the case of distributions involving multiple properties or distributions of hot and cold

[140] *See* Eric Sloan, Judd Sher, Matthew Sullivan, and Julia Trossen, "Order in the Court: Why Ordering Matters in Partnership Transactions," *Tax Notes*, Aug. 27, 2007 (illustrating overexposure to section 704(c) amounts from partnership distributions).

[141] Although we are not recommending in this Report that taxpayers be permitted to swap reverse section 704(c) amounts to account for the distortive effects of partnership distributions in other situations, such an approach may have merit beyond section 751(b). For example, if a partnership only holds stock of a corporation and revalues that stock in connection with the partial redemption of a partner, the failure to swap the remaining section 704(c) amounts to account for the distributee partner's share of gain in the partnership and the distributed stock can over- or under-expose both the distributee partner and the non-distributee partners to gain (*i.e.*, create inside-outside basis disparities). *See* Ray, *Dividing the Indivisible: Identifying the "Property" in Partnership Transactions*, The Tax Magazine (Feb. 11, 2022) for a detailed discussion on broader applications of swapping reverse section 704(c) amounts.

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assets, it has some analytical appeal." While some guidance regarding section 751(b) has been issued (in the form of the Proposed 751(b) Regulations), we continue to believe that additional guidance regarding the intersection of section 704(c) and section 751(b) would be worthwhile.

On November 3, 2014, Treasury and the IRS promulgated the Proposed 751(b) Regulations. In the preamble to the Proposed 751(b) Regulations, Treasury and the IRS acknowledged the approach we described in the First 751(b) Report but did not adopt the approach. Instead, the preamble to the Proposed 751(b) Regulations stated that the approach merited further consideration and requested comments on the permissibility of narrowing the application of section 751(b) by allowing partners to swap reverse section 704(c) amounts resulting from a partnership distribution to minimize the situations in which section 751(b) would otherwise apply.

Following the Proposed 751(b) Regulations' request for comments on this approach, we further discussed the concept of the Proposed Regulations requiring partners to exchange reverse section 704(c) amounts and again recommended the application of this approach in Report No. 1329 (the "**Second 751(b) Report**," and, together with the First 751(b) Report, the "**Prior 751(b) Reports**"). As we continue to believe there is merit to this approach, this Report once more endorses the recommendations of the Prior 751(b) Reports to require partners to exchange reverse section 704(c) amounts resulting from partnership distributions.

> **Example 20**.[142] X, Y and Z are equal members in LLC, which owns two assets, both of which are hot assets and both of which generate the same type of income. Asset 1 has a tax basis of $0 and a fair market value of $250. Asset 2 has a tax basis of $0 and a fair market value of $50. There are no section 704(c) amounts in either asset, each member has a $0 basis in its LLC interest, and LLC has a section 754 election in effect. LLC distributes Asset 2 to Z in partial redemption of Z's LLC interest, reducing Z's LLC interest to 20 percent. Z takes Asset 2 with a $0 basis under section 732(a).

Prop. Treas. Reg. §1.751-1(b)(2)(iv) would require LLC to revalue its assets immediately before the distribution, thus creating reverse section 704(c) amounts of $250 in Asset 1 and $50 in Asset 2. X, Y and Z would each have an $83.33 share of the reverse section 704(c) gain in Asset 1 and a $16.67 share of the reverse section 704(c) gain in Asset 2. As a result of the distribution of Asset 2 to Z, each of A's and B's shares of LLC's total hot-asset gain has decreased from $100 to $83.33, which is their section 751(b) amount under the Proposed 751(b) Regulations, and therefore each of A and B would be required to recognize an equal amount of ordinary income ($16.67 each). Under Prop. Treas. Reg. §1.751-1(b)(3)(iii), LLC would be required to increase its basis in Asset 2 to $33.33, and

[142] This example is based on Example 2 in the First 751(b) Report and Example 5 in the Second 751(b) Report.

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Z would recognize \$33.33 of capital gain under the mandatory gain recognition rule of Prop. Treas. Reg. §1.751-1(b)(3)(iii)(A).[143]

Section 751(b) is, in our view, properly applied to ensure that the correct amount of income is recognized by the appropriate person at the time the partnership recognized that income (or, in the case of distributed property, when the distributee disposes of the property in a taxable transaction). Section 751(b) should not accelerate the recognition of income or gain. Moreover, as noted in the Prior 751(b) Reports, the application of section 751(b) to such a distribution does not seem appropriate. As the LLC in this example has never owned cold assets, neither X nor Y has exchanged an interest in a hot asset for a cold asset. Instead, each has exchanged its indirect interest in a hot asset for a larger interest in the LLC, which owns only hot assets. As this example demonstrates, the application of section 751(b) presumably would be triggered by any distribution of hot assets to a partner, without regard to the composition of the remaining assets in the partnership. Yet, the language of section 751(b) seems to require an exchange of partnership hot assets for partnership cold assets for section 751(b) to apply, in accordance with its legislative history,[144] thus intimating that the application of section 751(b) would be inappropriate in a situation in which a partnership does not hold cold assets.

Viewed differently, the distribution of Asset 2 to Z has the effect of shifting \$50 of reverse 704(c) gain in Asset 2 from X and Y to Z. If the three members were permitted or required, in effect, to exchange reverse section 704(c) amounts (as between distributed hot assets, on the one hand, and retained hot assets, on the other hand) in connection with the distribution, the following would occur: In connection with the revaluation of the partnership's assets, Z's share of reverse section 704(c) gain in Asset 2 would be increased from \$16.77 to \$50, and its share of reverse 704(c) gain in Asset 1 would be decreased by the same amount (from \$83.33 to \$50). Correspondingly, the reverse section 704(c) gain of X and Y in Asset 2 would be decreased to \$0, while each member's section 704(c) gain in Asset 1 would be increased to \$100. This would allow for the total reverse 704(c) gain of X and Y to be preserved, while simultaneously preventing the application of section 751(b) in cases when it should not apply, including, for example, when the partnership owns only hot assets.

In the Second 751(b) Report, we noted that "[w]hile the approach requires different tracking of section 704(c) amounts, section 704(c) amounts already have to be tracked, and we believe tracking different sharing ratios in hot assets would not result in a material increase in the administrative burden on partnerships." We reiterate this belief in this Report and the belief that this approach has merit. As such, we recommend that Treas.

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[143] As a result of the application of the mandatory recognition rule, Z's recognition of capital gain would result in Z's outside basis in LLC increasing before the distribution by the amount of the gain recognized, thus preventing a section 734(b) adjustment.

[144] Section 751(b) "is not applicable to a distribution to a partner of his proportionate share of partnership inventory items or unrealized receivables where such a distribution is not in exchange for his interest in other partnership property." Conf. Rep. to Accompany H.R. 8300, pt 2, at 15.

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Reg. § 1.704-3(a)(6) be amended to provide that a distributee-partner's share of reverse section 704(c) gain resulting from a distribution of hot assets by the partnership should be increased to the full amount of the gain in the distributed hot assets, as limited by the extent to which the distributee-partner's share of reverse section 704(c) gain in the partnership's retained hot assets can be decreased, provided that the distributed hot assets have the same type of built-in gain that the partnership has in its retained assets.

l. Non-basis derivative issues (e.g., appreciated/depreciated debt instruments)

As noted earlier, it is generally believed that section 704(c)(1)(A) applies only to basis derivative items. There are numerous situations, however, in which limiting the application of section 704(c) to basis derivative items may frustrate the purpose of the Code section.[145] For example, if a partner contributes a debt instrument to a partnership, the contributing partner's capital account is credited with the debt instrument's fair market value. The difference between the contributing partner's tax basis in the contributed debt instrument and the fair market value of the debt instrument at the time of the contribution is subject to section 704(c). As a result, any built-in gain or loss inherent in the contributed debt instrument would be allocated to the contributing partner upon the partnership's taxable disposition of the contributed debt instrument.[146] However, in certain fact patterns, if the debt instrument remains outstanding until maturity and is repaid according to its terms, no gain or loss is recognized from a tax perspective on the retirement of the debt. The issues arising from this are illustrated by the following example.

> **Example 21**. X and Y are equal members of LLC. X contributes a debt instrument that earns interest at a rate of 12 percent when the market rate is 10 percent; the debt instrument has two years remaining until maturity, a face amount of $100, basis of $100 and a fair market value of $104. (The difference between the fair market value and tax basis is attributable entirely to the fact that the debt instrument earns an above-market interest rate.) Y contributes $104 of cash. LLC agrees to use the traditional method with respect to the debt instrument. LLC holds the debt instrument until maturity, at which time it

[145] *See, e.g.*, Monte Jackel, *Value-Basis Disparities and Other Aberrations Involving the Contribution and Distribution of Debt Instruments to and from Partnerships*, 78 Taxes 252, 254 (2000).

[146] By referring to items of income and loss with respect to property, the text of the Code may create some confusion as to whether section 704(c) applies to operating income and loss arising from contributed property. The legislative history is quite clear that section 704(c) was not intended to operate in such a manner, stating specifically that "[i]t was not intended that Treasury regulations require variations between the basis and fair market value of contributed property to be eliminated by allocations of operating income and loss attributable to the property (other than depreciation, depletion, and similar items). Joint Comm. on Tax., "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-6-98, at 215.

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receives $100 from the obligor, recognizing a $4 book loss and no tax gain or loss.

The members' capital accounts are as follows:

	X		*Y*	
	Book	Tax	Book	Tax
Contribution	$104	$100	$104	$104
Year 1 Interest Income	6	6	6	6
Year 2 Interest Income	6	6	6	6
Retirement	(2)	0	(2)	0
Ending Capital Accounts	$114	$112	$114	$116

As illustrated by this example, because the members agreed to use the traditional method with respect to the debt instrument and because the interest income is not treated as a basis derivative amount that must be allocated specially even under the traditional method, the members' capital accounts reflect the shifting of half of the gain in the debt instrument from X to Y.[147]

There are two potential solutions to address this. First, solely for tax purposes, the LLC could allocate taxable income equal to the above-market portion of the interest income to X as the contributing partner. This would result in Y being allocated, solely for tax purposes, a correspondingly smaller amount of interest income.

	X		*Y*	
	Book	Tax	Book	Tax
Contribution	$104	$100	$104	$104
Year 1 Interest Income	6	7	6	5
Year 2 Interest Income	6	7	6	5
Retirement	(2)	0	(2)	0
Ending Capital Accounts	$114	$114	$114	$114

[147] We note that a similar phenomenon exists when a liability that has a negative fair market value that differs from its face value is contributed to a partnership. We would be happy to further discuss and/or provide proposals to address the issues posed by such liabilities if helpful.

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This approach would eliminate the disparity between the members' book and tax capital accounts but is inconsistent with the way section 704(c) was intended to and is understood to operate with regard to basis derivative items. Moreover, it would have the effect of creating, rather than reducing, disparities in the short run, although it would be anticipated that the disparities would be eliminated on retirement of the debt instrument.

It may be more fruitful to work within the existing framework of section 704(c). In that case, if the LLC were to use the remedial allocation method, it could allocate a $2 tax loss to Y and $2 of taxable gain to X to cure, or remediate, the ceiling limitation and align the members' book and tax capital accounts, as follows.[148]

	X		*Y*	
	Book	Tax	Book	Tax
Contribution	$104	$100	$104	$104
Year 1 Interest Income	6	6	6	6
Year 2 Interest Income	6	6	6	6
Book Loss on Retirement	(2)	0	(2)	0
Remedial Allocation		2		(2)
Ending Capital Accounts	$114	$114	$114	$114

To eliminate the potential for permanent book-tax disparities to arise with respect to the contribution of appreciated or depreciated debt instruments (and other similar types of assets), we recommend that Treasury and the IRS permit partnerships to cure ceiling distortions that will arise in the future (e.g., on the retirement of a debt instrument) with non-basis derivative income (such as interest income) earned from the contributed property notwithstanding that the income may be of a different character (i.e., ordinary) than the ceiling limited loss (or gain) will be (i.e., capital[149]) and notwithstanding that the curative

[148] Before the enactment of section 704(c)(1)(C), similar issues arose in connection with the contribution of a debt instrument with a basis in excess of the debt instrument's fair market value on the date of contribution – upon retirement of the debt instrument, the partnership would have book gain but no taxable gain such that, absent the application of section 704(c), the partners' book and tax capital accounts would not match. Because section 704(c)(1)(C) essentially "hives off" the loss portion of the basis, however, the built-in loss can no longer be transferred. Nevertheless, similar issues can arise when a debt instrument held by a partnership is revalued, giving rise to a reverse gain or loss layer.

[149] Under section 1271, the gain or loss on the retirement of a debt instrument is capital.

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allocation will be made in one or more years before the ceiling limited loss (or gain) will arise.[150, 151]

m. Recognition across multiple layers

There is limited guidance regarding section 704(c) allocations in the situation in which a piece of property has multiple section 704(c) layers (whether forward, reverse, or both).[152]

In our Prior Layers Report, we recommended that tax items could permissibly be allocated among multiple section 704(c) layers using one of three methods: (1) allocating items to the oldest layer first, (2) allocating items to the newest layer first or (3) allocating items pro rata among the layers. In the preamble to the 2014 proposed regulations that would amend Treas. Reg. § 1.704-3 to clarify the interaction between multiple section 704(c) and reverse section 704(c) layers and allocations of tax items between the multiple layers,[153] Treasury and the IRS agreed "that partnerships should be permitted to use any reasonable method in allocating tax items," acknowledging that each of these methods would be reasonable, but declined to adopt a default rule because "no single method is more appropriate than other methods."[154] The preamble then specifically states that "a

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[150] Although the focus of this Part K has been on debt instruments, the same principles and recommendation apply with respect to other appreciated or depreciated property that generates non-basis derivative income, including but not limited to leases that generate rental income, REIT stock that pays a REIT capital gain dividend, CFC stock that generates subpart F income, and PFIC stock that generates a QEF inclusion.

[151] A potential third solution would be to adopt the amortizable bond premium regime under section 171. Under that regime, if a holder's tax basis in a debt instrument, immediately after its acquisition of the debt instrument exceeds its stated redemption price at maturity ("**SRPM**"), then the holder is permitted to elect to amortize the excess, also known as the bond premium, over the term of the debt instrument. Because these rules look to the tax basis of the debt instrument, it is not clear whether, in the absence of a specific rule, they can be applied in the case of a debt instrument with a section 704(b) *book* basis in excess of SRPM. Treasury and the IRS could consider adopting a specific rule to that effect, though we note that this would address only the issue with respect to appreciated debt instruments but not the similar issues raised by other appreciated or depreciated property.

[152] In PLR 200829023 (July 18, 2008), a partner contributed section 704(c) property to a partnership. Subsequently, the property appreciated in value and the partnership made multiple revaluations, resulting in reverse section 704(c) layers with respect to the property. The reverse section 704(c) gain on the property was greater than the forward section 704(c) gain. The partnership then exchanged the section 704(c) property for like-kind property and boot in an exchange qualifying for tax-deferred treatment under section 1031 (thus making the like-kind property received in the exchange successor property for purposes of the Substituted Property Rules). The partnership allocated the tax gain that exceeded book gain on a last-in, first out basis (allocating the gain to the most recently created section 704(c) layers first until exhausted). The IRS ruled that the taxpayer's allocation method was reasonable and resulted in an appropriate adjustment under Treas. Reg. § 1.704-3(a)(8). However, the IRS explicitly noted that "no inference should be drawn that there may not be other appropriate methodologies."

[153] 79 Fed. Reg. 3042, 3054 (Jan. 16, 2014).

[154] *Id*.

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partnership may use any reasonable method to allocate items of income, gain, loss, and deduction associated with an item of property among the property's forward and reverse section 704(c) layers subject to the anti-abuse rule in § 1.704-3(a)(10)."[155]

We reiterate our request that guidance confirm that reasonable methods include "last in first out" (the "**LIFO Method**"), first in first out (the "**FIFO Method**"), or pro rata across all the layers (the "**Pro Rata Method**"), and, in light of the statement in the preamble to the 2014 proposed regulations, also include a discretionary method (the "**Discretionary Method**").

Example 22. X and Y are equal members of LLC. X contributes Asset 1 with a basis of $40 and fair market value of $100, and Y contributes $100 in cash. As a result of the contribution, X has a $60 forward section 704(c) layer with respect to Asset 1. A year later, when the fair market value of Asset 1 has increased to $200, LLC admits Z, who contributes $150 cash for a 1/3 interest in LLC. Immediately before Z's admission, LLC revalues Asset 1, creating a $50 reverse section 704(c) layer in Asset 1 with respect to X and a $50 reverse section 704(c) layer in Asset 1 with respect to Y. (X's and Y's capital accounts are each increased from $100 to $150.)

Asset 1 now has two section 704(c) layers.

	Forward section 704(c) Layer	***Reverse section 704(c) Layer***	***Total***
X	$60	$50	$110
Y	--	$50	$50
Total	$60	$100	$160

When the fair market value of Asset 1 is $200, LLC sells a 31.25% undivided interest in Asset 1 to a third party for $62.50, recognizing no book gain but $50 of tax gain.[156] There is little guidance regarding the manner in which this gain should be allocated between X and Y. (It is clear that Z should not be allocated any of the gain because LLC recognized no book gain on the sale.)

FIFO Method: Under the FIFO method, the $50 of gain would be allocated to X with respect to X's forward section 704(c) layer.

[155] *Id*.

[156] The interest in Asset 1 sold by LLC represents a 31.25% interest in Asset 1 ($62.5/$200=31.25%). Accordingly, the tax basis attributable to such interest is $12.50 (31.25%*$40 basis=$12.50). See Treas. Reg. § 61-6, which provides that "[w]hen a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part." Therefore, the gain on the sale is $50 ($62.50-$12.50=$50).

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> LIFO Method: Under the LIFO method, the $50 gain would be allocated to the reverse section 704(c) layer. Whether this would be allocated entirely to X, entirely to Y, equally to both, or in some other proportion, is in the discretion of the LLC.
>
> Pro Rata Method: Under the Pro Rata Method, the $50 of gain would be allocated between X and Y in proportion to their total section 704(c) gain in Asset 1— around $34.38 to X and $15.62 to Y.
>
> Discretionary Method: Under a Discretionary Method, the $50 of gain could be allocated in any reasonable manner, including (i) proportionately between the layers, with the portion allocated to the reverse layer being allocated entirely to X, entirely to Y, or proportionately between them or (ii) in any other manner.

In each case, the choice of method would be subject to the general reasonableness requirement of the section 704(c) regulations.

n. Interaction with capitalization rules

Section 263A requires that certain direct and indirect costs be capitalized into the basis of property, or included in inventory costs, rather than deducted. Indirect costs include, among other things, depreciation and amortization of equipment and facilities used to produce inventory.[157] Thus, when section 263A applies, items such as depreciation that would have been deducted by the partnership and specially allocated among the partners under section 704(c)(1)(A) instead are capitalized.

It is not clear how section 704(c) applies in such a situation,[158] and there is no statutory, regulatory or administrative guidance regarding this issue. Because the property into which the relevant costs are capitalized is not itself section 704(c) property, it may be possible to argue that section 704(c) does not dictate the tax allocation of income from the sale of the inventory. This, however, could well result in the inappropriate basis shifting that the section 704(c) rules attempt to prevent.[159]

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[157] Treas. Reg. § 1.263A-1(e)(3)(ii)(I).

[158] *See* Gary Huffman, *704(c) Meets 263A: Contributions of Depreciable Property to Partnerships*, 98 *J. Tax'n* 149 (2003), for a discussion of this issue and potential solutions, including the approach we recommended below.

[159] It has been observed that taxpayers could take the position that section 263A does not apply to the extent the relevant depreciable property is section 704(c) property. *See, e.g.*, Gary Huffman, *704(c) Meets 263A: Contributions of Depreciable Property to Partnerships*, 98 *J. Tax'n* 149 (2003). Although it is difficult to find any support for this approach, it would allow for section 704(c) to operate to prevent gain and loss shifting and, to the extent inventory is sold in the year in which it is produced, would not affect the timing of (….continued)

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> **Example 23**. X and Y are equal members of LLC. X contributes Asset 1, which has a tax basis of $60 and a fair market value of $100, has five years remaining on its cost recovery schedule, and is depreciable using the straight-line method. B contributes $100 of cash, which the LLC uses to purchase inventory for resale.
>
> During Year 1, LLC claims $20 of section 704(b) book depreciation and $12 of tax depreciation with respect to Asset 1 and capitalizes the depreciation into its cost of goods sold for both book and tax purposes. As a result, the section 704(b) book basis of LLC's inventory is increased to $120, and the tax basis of its inventory is increased to $112.
>
> On the first day of year 2, LLC sells all of its inventory for $114, recognizing a $6 section 704(b) loss and $2 of taxable income.
>
> But for the application of section 263A, for Year 1, LLC would have allocated the $20 of section 704(b) depreciation equally to X and Y and would have allocated $2 of tax depreciation to X and $10 of tax depreciation to Y.
>
> For Year 2, disregarding the depreciation from Asset 1 and but for the application of section 263A, LLC would have recognized $14 of section 704(b) income and $14 of taxable income and would have allocated the $14 of section 704(b) book and tax income from the sale of inventory equally to X and Y. Thus, X's cumulative taxable income would have been $5 ($7 of income less $2 of depreciation), and Y would have a cumulative taxable loss of $3 ($7 of income less $10 of depreciation). (This would have equaled LLC's cumulative $2 of taxable income.)
>
> Although it is clear that, with the application of section 263A, LLC recognizes a $6 section 704(b) book loss that is allocated equally to X and Y, it is not entirely clear whether the $2 taxable income can or must be allocated entirely to X (which, as described immediately above, would have been the result absent the application of section 263A).

The existing regulations address the transmutation of section 704(c) property and capitalization in a number of instances. For example, Treas. Reg. § 1.704-3(a)(8)(i) and (ii) address the disposition of section 704(c) property in nonrecognition transactions and installment sales, respectively, and Treas. Reg. § 1.704-3(a)(8)(iii) addresses the conversion of a contributed contract into property acquired pursuant to the contract. In each case, the regulations provide that the new property is treated as section 704(c) property, with "appropriate adjustments" being made to reflect gain or loss recognition. In

income recognition. To the extent, however, that inventory is not sold in the year in which it is produced, the failure to apply section 263A would allow for the deferral of income (as depreciation would be taken into account in the year of production rather than in the year of the sale of the inventory), which runs counter to the policy (and text) of section 263A.

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addition, and most relevant to this discussion, Treas. Reg. § 1.704-3(a)(8)(iv) addresses capitalized contingent liabilities and specifically provides that "the item or items to which such cost is properly capitalized is treated as section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized."[160]

To harmonize section 704(c)(1)(A) with section 263A, we recommend that the regulations be amended to confirm (or clarify) that (i) if costs with respect to section 704(c) property are properly capitalized into inventory or other property, the inventory or other property should be treated as section 704(c) property with the same amount of built-in gain or built-in loss as corresponds to the amount capitalized and (ii) the allocation method with respect to the inventory must be consistent with the method chosen for the original property.[161]

[160] Treas. Reg. § 1.704-3(a)(8)(iv) addresses only built-in loss because contingent liabilities, or "§ 1.752-7 liabilities," in the parlance of the regulations, are definitionally built-in loss items. Treas. Reg. § 704-3(a)(12). *See also* the Contingent Liabilities Report.

[161] We note that Treas. Reg. § 1.704-3(a)(8)(i), (ii) and (iii) all include this additional requirement. While Treas. Reg. § 1.704-3(a)(8)(iv) does not, we assume that may have been an oversight, and we recommend that this requirement be similarly added there as well.

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